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# UNDERSTANDING HEDGE FUND ADVISER REGULATION

Thierry Olivier Desmet<sup>1</sup>

## I. INTRODUCTION

For the past several years, hedge funds have reached a near-mythical status in the securities industry, inspiring feelings of admiration and fascination but also envy and fear in many people.<sup>2</sup> Every major newspaper publishes articles on hedge funds on a weekly basis. Yet, for all of their popularity and notoriety, few people actually understand what hedge funds are, what they do, and what laws, if any, regulate them.<sup>3</sup> This article explains why hedge funds have become such an alluring investment fad and offers an introduction to the regulations that have been promulgated to oversee the activities of hedge fund advisers.

Part II will explain what hedge funds are and what their investment strategies generally entail. Part III will examine the compensation structure that has enabled hedge fund advisers to make substantial sums of money and whether the high returns on investment they have generated are likely to continue. Part IV will identify the types of investors who traditionally have invested in hedge funds and whether this has changed in the past several years. Part V will examine particular problems that hedge funds may cause for the economy and the investing public. Part VI will summarize the regulations imposed on hedge fund advisers in the United

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1. Branch Chief in the Enforcement Division of the United States Securities & Exchange Commission. The Securities & Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission and its staff.

2. *Hedge-Fund Envy*, THE ECONOMIST, March 15, 2007; Clare Francis and Joe Brennan, *Ireland. Shed Light on the Dark Art of Hedge Fund Investment*, THE TIMES OF LONDON, March 12, 2006.

3. Riva D. Atlas, *Want to Start a Hedge Fund? First, Read This Book*, N.Y. TIMES, December 22, 2005.

States as well as the controversial rule by the U.S. Securities & Exchange Commission (the “Commission”), now vacated, that would have required most hedge fund advisers to register as investment advisers. Part VI will also highlight the Commission’s new antifraud rule, adopted in July 2007 to protect investors in pooled investment vehicles. Part VII will examine the main arguments made by opponents of hedge fund adviser regulation. Part VIII will briefly comment on hedge fund regulation outside of the United States. Part IX will summarize a few of the best known cases brought against hedge funds and their advisers by securities regulators and criminal authorities. Finally, Part X will conclude the article.

## II. DEFINITION OF A HEDGE FUND

Even though hedge funds increasingly have played an important role in the public markets, most people outside of the securities industry do not know what they are or how they operate.<sup>4</sup> Even some people who invest in hedge funds, seduced by promises of extraordinary returns, do not completely understand how they differ from other investment options.<sup>5</sup> Moreover, different people use the term “hedge fund” to refer to different investment mechanisms.

A hedge fund is a private pool of capital, typically formed as a limited partnership or limited liability company to obtain flow-through tax treatment, through which investments are made using a strategy designed to “hedge” against risk in equity investments.<sup>6</sup> Until recently,<sup>7</sup> hedge funds have benefited from relative secrecy and limited regulation.<sup>7</sup> For example, unlike mutual funds, hedge funds have never had to comply with requirements for independent boards of directors.<sup>8</sup>

Hedge funds traditionally combine “long” positions with “short” positions, which allow them to “hedge” their bets on stock or commodity prices.<sup>9</sup> By combining “long” bets that some positions will rise with “short” bets that some other positions will fall, hedge funds essentially

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4. There is no statutory or regulatory definition of hedge fund. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,055 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. 1A-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

5. M.P. Dunleavy, *Does “Hedge Fund” Mean Anything Anymore*, N.Y. TIMES, October 9, 2005.

6. Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 J. ECON. PERSP. 189, 190 (1999); Ralph S. Janvey, *Hedge Funds*, 21 REV. OF SEC. & COMMODITIES REG. 91, 91 (1998).

7. Martin Dickson, *Lombard: Lifting Veil on Hedge Fund Secrecy*, FT.com, February 16, 2006.

8. See *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*6 (D.C. Cir. June 23, 2006).

9. Jane J. Kim, *Selling Short In Your 401-K — ‘Hedged’ Mutual Funds Seek to Become Option In Retirement Plans; IBM Wary of Risks*, WALL ST. J., August 17, 2005.

minimize the risk of loss in any one position.<sup>10</sup> In other words, by shorting stocks a hedge fund can limit its exposure if the market, or a particular sector, dropped, while at the same time reaping gains in other stocks if the market rose.<sup>11</sup> Under this traditional hedge fund model, the investment goal is to generate absolute returns regardless of whether the market rises or falls, as opposed to the more limited goal of outperforming other investors or market indices.<sup>12</sup>

In addition to a traditional long/short strategy to offset adverse market movements, many hedge fund managers typically look for clever ways to exploit market inefficiencies or wrinkles and invest not only in stock and commodities, but in bonds, currencies, options, derivatives, real estate, arbitrage, or any combination of the above.<sup>13</sup> Hedge funds also typically employ leverage through the use of margin debt and other borrowings to enhance returns.<sup>14</sup> Dynamic hedge fund managers continually adapt their investment strategies to the market. For example, more and more hedge fund managers have been investing in private-equity holdings.<sup>15</sup>

Unlike mutual funds which own very diversified portfolios, hedge funds sometimes invest a large amount of money in one single position.<sup>16</sup> Some powerful hedge funds have even been known to build a large position in a company in secret, through instruments known as “contracts for difference,” derivatives that allow them to bet on price moves without taking full ownership of the shares but which do not have to be disclosed to the company in question.<sup>17</sup>

Other hedge funds are more like “funds of hedge funds” which means

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10. A short seller sells a security that the seller has borrowed in anticipation of making a profit by paying for it after the price drops. Alan Murray, *Hedge Funds Need to Open Up*, *Wall. St. J.*, April 5, 2006; Clare Francis and Joe Brennan, *Ireland: Shed Light on the Dark Art of Hedge Fund Investment*, *THE TIMES OF LONDON*, March 12, 2006.

11. M.P. Dunleavy, *Does “Hedge Fund” Mean Anything Anymore*, *N.Y. TIMES*, October 9, 2005.

12. *Hedge Fund Is Now A Meaningless Term; Going Back to Beta Suggests Trouble Generating Alpha*, *FINANCIAL TIMES*, August 18, 2005.

13. Ben White, *As Hedge Funds Go Mainstream, Risk Is Magnified*, *THE WASHINGTON POST*, August 11, 2005. Some unconventional hedge funds are even involved in aircraft leasing, direct lending, and financing in the area of utilities. Ananda Cantrell, *How Hedge Funds Make Money Now*, *CNNMoney.com*, August 4, 2005; David Lieberman and Laura Petrecca, *Cruise Seeks Financial Backing From Hedge Funds*, *USA TODAY*, August 24, 2006.

14. James Grant, *Clipped Hedges*, *FORBES*, June 10, 2002.

15. Lawrence C. Strauss, *Hedge Funds – Fund of Information: Conflicts: Big problem or Big Hype?*, *BARRON’S*, August 29, 2005.

16. Susan Chandler, *Hedge Funds Put the Pressure On*, *CHI. TRIB.*, January 27, 2006. Amaranth Advisors disclosed a \$6 billion loss, or 65% of its assets, in September 2006, due to bad bets in the volatile natural gas market, the biggest hedge fund loss ever. Ann Davis, *Regulators Scrutinize Amaranth*, *WALL ST. J.*, September 25, 2006. Even more recently, two large Bear Stearns hedge funds were reportedly close to collapse after investing heavily in sub-prime loans. Jeremy Herron, *What Would Collapse of Hedge Funds Mean?*, *THE SEATTLE TIMES*, June 21, 2007.

17. Lina Saigol, *Hedge Funds Are Very Keen to Flex Their Secretive Shareholding Muscle*, *FINANCIAL TIMES*, August 9, 2005.

that they distribute investors' monies over a diversified pool of hedge funds, typically five to fifty hedge funds, lessening the risk of fraud and losses.<sup>18</sup> This popular mechanism provides some diversification and a lower margin of risk.<sup>19</sup> Funds of hedge funds are typically assembled by banks and money management firms.<sup>20</sup> The money raised by these funds-of-funds firms may account for as much as 40% of all monies currently raised by hedge funds.<sup>21</sup> There are over fifty registered funds of hedge funds that offer or plan to offer their shares publicly.<sup>22</sup>

Still other so-called hedge funds are nothing more than watered-down versions of what it traditionally meant to be a hedge fund and look more like leveraged long funds<sup>23</sup> or index funds.<sup>24</sup> As this discussion demonstrates, the hedge fund industry is far from monolithic, and hedge funds today vary enormously, not only in structure and investment style, but also in management.<sup>25</sup>

Traditional hedge funds have steep investment minimums, from \$1 million to as high as \$50 million per investor.<sup>26</sup> However, "funds of funds" have much lower thresholds, with minimum investments as low as \$25,000.<sup>27</sup> The largest hedge funds in the world have over \$1 billion under management, although many other hedge funds have less than \$200 million under management.<sup>28</sup> Many hedge funds have "lockup" arrangements whereby an investor's initial investment is tied up in the fund for a set amount of time, much like a bank certificate of deposit.<sup>29</sup> Beyond that lockup period, which provides a stable asset base, most hedge funds allow investors to withdraw money on a quarterly or monthly basis.<sup>30</sup> Other hedge funds allow their investors to redeem their interests quite quickly

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18. Robert Pozen, *Reporting Standards For Hedge Funds Must Be Raised*, FINANCIAL TIMES, January 12, 2006.

19. Geraldine Fabrikant, *Want a Hedge Fund? Here's Your Homework*, N.Y. TIMES, September 11, 2005.

20. Geraldine Fabrikant, *Hedge Funds Work for Yale, But Will They Work for You?*, N.Y. TIMES, November 27, 2005.

21. Henny Sender, *For Hedge Funds, The Money Spigot Flows Both Ways*, WALL ST. J., December 22, 2005; Pauline Skypala, *Hedge Funds of Funds Booming*, FT.com, September 26, 2004.

22. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,057 (Dec. 10, 2004) (Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

23. *Hedge Fund Is Now A Meaningless Term, Going Back to Beta Suggests Trouble Generating Alpha*, FINANCIAL TIMES, August 18, 2005.

24. M.P. Dunleavy, *Does "Hedge Fund" Mean Anything Anymore*, N.Y. TIMES, October 9, 2005.

25. Martin Dickson, *Hedge Funds*, FINANCIAL TIMES, July 30, 2005.

26. M.P. Dunleavy, *Does "Hedge Fund" Mean Anything Anymore*, N.Y. TIMES, October 9, 2005.

27. *Id.*

28. Riva D. Atlas, *Want to Start a Hedge Fund? First, Read This Book*, N.Y. TIMES, December 22, 2005; The average hedge fund still has less than \$200 million in assets. Riva D. Atlas, *From Mutual to Hedge Funds, and Back Again*, N.Y. TIMES, January 8, 2006.

29. Gretchen Morgenson, *A Hedge Fund Falls Off the Face of the Earth*, N.Y. TIMES, August 28, 2005.

30. Jeff Benjamin, *Hedge Funds Exploit a Loophole; Some Funds Extend Lockup*, INVESTMENT NEWS, September 26, 2005.

after their initial investment.<sup>31</sup>

In the United States, the highest concentration of hedge fund advisers appears to be in Connecticut, where at least 512 hedge funds, managing around \$111 billion, existed as of late September 2005.<sup>32</sup> Many hedge fund advisers also operate funds abroad. In fact, as of late January 2006, 113 hedge fund managers based outside of the United States had registered with the Commission.<sup>33</sup> The Cayman Islands is the most popular location for hedge funds abroad.<sup>34</sup> The United Kingdom and Hong Kong are also primary overseas locations of hedge funds managers.<sup>35</sup> Australia has also become a vibrant center for hedge funds, relying on a local investor base, as opposed to hedge funds in Singapore and Hong Kong which mostly depend on offshore investors.<sup>36</sup>

In the last few years, hedge fund advisers, led by the Managed Funds Association, the hedge fund industry's main trade group, have become politically savvy.<sup>37</sup> They hired a number of lobbying groups and contributed over \$1 million to congressional candidates and the Republican and Democratic parties in the 2005-2006 campaign.<sup>38</sup>

The popularity of hedge funds has resulted in a brain drain from top conventional mutual funds to hedge funds where the lure of stratospheric rewards and unconventional investment strategies has proven too attractive for many to decline.<sup>39</sup> Lately, however, in part due to competition and more modest performances than in previous years, the industry has seen a number of hedge funds close and traders move back to more traditional employment with mutual funds.<sup>40</sup>

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31. Gretchen Morgenson, *A Hedge Fund Falls Off the Face of the Earth*, N.Y. TIMES, August 28, 2005.

32. Louise Story, *Chatting Among the Hedge*, N.Y. TIMES, September 30, 2005.

33. Francesco Guerrera, Andrew Parker, and Stephen Schurr, *Managers to Face Regular Inspections*, FINANCIAL TIMES, January 30, 2006.

34. Ken Hoover, *Hedge Funds' Explosive Growth Spurs SEC's Registration Drive*, INVESTOR'S BUSINESS DAILY, January 26, 2006; Phil Davis, *Hedge Fund Failures Rising Sharply*, FINANCIAL TIMES, August 14, 2006.

35. Francesco Guerrera, Andrew Parker, and Stephen Schurr, *Deadline Approaches As SEC Takes Clippers to Hedge Funds*, FINANCIAL TIMES, January 30, 2006.

36. Lachlan Colquhoun, *Australians Hedge Their Bets on Alternative Funds*, FINANCIAL TIMES, December 12, 2005.

37. Kara Scannell and Brody Mullins, *Politics & Economics: Hedge Funds Sharpen Their Political Game – Amid Increased Regulatory Focus, Industry Players Step Up Lobbying and Campaign Giving*, WALL. ST. J., June 28, 2006; Kara Scannell and Brody Mullins, *Hedge Funds Coming of Age Politically*, WALL. ST. J., April 19, 2007.

38. Kara Scannell and Brody Mullins, *Politics & Economics: Hedge Funds Sharpen Their Political Game – Amid Increased Regulatory Focus, Industry Players Step Up Lobbying and Campaign Giving*, WALL. ST. J., June 28, 2006.

39. Riva D. Atlas, *From Mutual to Hedge Funds, and Back Again*, N.Y. TIMES, January 8, 2006.

40. *Id*

### III. HEDGE FUND ADVISER COMPENSATION

Hedge fund managers charge hefty fees well in excess of those usually associated with money management.<sup>41</sup> Typically, these fees include a management fee of 1 to 2% of an investor's assets under management in addition to a bonus or incentive fee of 15 to 20% of the fund's profits.<sup>42</sup> In a year with generally good performance from the market averages, the managers of the largest hedge funds can earn several hundred million dollars by substantially outperforming them.<sup>43</sup> Other hedge fund advisers simply take an incentive fee based on the fund's profits.<sup>44</sup>

Some studies indicate that hedge funds' returns have a fifteen-year average of about 15%, but were down to around 4% in 2005.<sup>45</sup> Since 2002, in fact, hedge funds listed in the Credit Suisse/Tremont Hedge Fund Index underperformed the S&P 500 two out of three years.<sup>46</sup> From 1993 until 2005, their return almost matched the 10.5% total return generated by the S&P 500 Index.<sup>47</sup>

Dependable ratings of hedge funds, and accurate statistics on their returns, are generally hard to find because of the secrecy that surrounds the hedge fund industry.<sup>48</sup> Several firms, such as Morningstar Inc., Reuters Group PLC, which owns Lipper Inc., and Sky Fund, are all in the process of compiling databases of hedge funds to provide accurate ratings that would focus on performance and historic returns as well as risk levels, management track records, and other important research factors.<sup>49</sup> These databases can be misleading. Indeed, only funds with good returns typically agree to provide statistics on their performance.<sup>50</sup> In addition,

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41. Michael Steinhardt, *Do You Really Need a Hedge Fund?*, WALL ST. J., April 14, 2006 (noting that in 2005 hedge funds earned \$16 billion in fees tied to assets under management alone).

42. M.P. Dunleavy, *Does "Hedge Fund" Mean Anything Anymore*, N.Y. TIMES, October 9, 2005. The fees charged by hedge funds are much higher than those charged by mutual funds. Riva D. Atlas, *From Mutual to Hedge Funds, and Back Again*, N.Y. TIMES, January 8, 2006.

43. Riva D. Atlas, *Want to Start a Hedge Fund? First, Read This Book*, N.Y. TIMES, December 22, 2005.

44. Gretchen Morgenson, *A Hedge Fund Falls Off the Face of the Earth*, N.Y. TIMES, August 28, 2005.

45. Hedge Fund Research, Inc., available at [www.hedgefundresearch.com](http://www.hedgefundresearch.com); Ben White, *As Hedge Funds Go Mainstream, Risk Is Magnified*, THE WASHINGTON POST, August 11, 2005. Sources disagree on hedge funds' exact rate of return in 2005. The Standard & Poor's hedge fund index, which only includes 42 funds that are still open for investment, returned 2.39% for 2005.

46. Michael Steinhardt, *Do You Really Need a Hedge Fund?*, WALL ST. J., April 14, 2006.

47. Michael Steinhardt, *Do You Really Need a Hedge Fund?*, WALL ST. J., April 14, 2006; Clare Francis and Joe Brennan, *Ireland: Shed Light on the Dark Art of Hedge Fund Investment*, THE TIMES OF LONDON, March 12, 2006.

48. Scott Patterson, *Race to Rate Hedge Funds Begins in Heavy Fog*, WALL ST. J., September 28, 2005.

49. *Id.*

50. Robert Pozen, *Reporting Standards For Hedge Funds Must Be Raised*, FINANCIAL TIMES, January 12, 2006; Laura Smitherman, *Hedging Concerns*, BALTIMORE SUN, July 30, 2006.

hedge fund managers typically choose the date from which they begin to report performance and therefore can ignore a bad year and simply select their first good year as the starting date, creating an upward bias.<sup>51</sup> Opponents of rating systems have also argued that hedge funds' strategies are so varied that comparisons would be nonsensical and unfair anyway.<sup>52</sup> Finally, the rates of return of illiquid investments such as real estate and esoteric interest rate swaps are particularly difficult to appraise and therefore make comparisons unfeasible.<sup>53</sup>

As more and more money flows into the hedge funds that are implementing successful investment strategies, the resulting competition makes it increasingly hard to generate stellar returns.<sup>54</sup> As the market becomes saturated, hedge funds have a harder time finding inefficiencies to exploit.<sup>55</sup> In 2005, overall returns in hedge funds were disappointing.<sup>56</sup> As a result, hedge fund managers may be continually looking for new strategies and exotic investment vehicles to be able to compete.<sup>57</sup> As more and more hedge funds resemble mutual funds, it is unclear that hedge fund advisers will be able to continue to charge a huge premium for their services.<sup>58</sup> For now, however, hedge fund fees seem to remain fairly inelastic and there are no signs of a downward trend in fee structure.<sup>59</sup> In fact, when hedge fund returns were low in late 2000 and in 2001, hedge fund fees remained very high.<sup>60</sup> These high fees can be explained by the fact that the hedge fund market is very fragmented, with investors scattered all over the world in thousands of different funds, and therefore no single, organized investor movement exists to bargain for lower fees.<sup>61</sup> Another reason for this inelasticity may be that when investors select a hedge fund

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51. Robert Pozen, Reporting Standards For Hedge Funds Must Be Raised, *FINANCIAL TIMES*, January 12, 2006; Jenny Anderson, *By the Numbers: Hedge Funds and Half-Truths*, *N.Y. TIMES*, January 20, 2006.

52. Scott Patterson, *Race to Rate Hedge Funds Begins in Heavy Fog*, *WALL ST. J.*, September 28, 2005.

53. Mark Gimein, *Is a Hedge Fund Shakeout Coming Soon?*, *N.Y. TIMES*, September 4, 2005.

54. *Hedge Fund Is Now a Meaningless Term: Going Back to Beta Suggests Trouble Generating Alpha*, *FINANCIAL TIMES*, August 18, 2005.

55. Rebecca Knight, *Mutual Friends Are Coming Home*, *FINANCIAL TIMES*, December 6, 2005; Ananda Cantrell, *How Hedge Funds Make Money Now*, *CNNMoney.com*, August 4, 2005; Daniel Gross, *Hedge Funds Are the New Mutual Funds*, *SLATE*, December 27, 2005.

56. *Growing Pains*, *Economist.com*, March 2, 2006.

57. Amanda Cantrell, *How Hedge Funds Make Money Now*, *CNNMoney.com*, August 4, 2005. For example, approximately 600 hedge funds with nearly \$100 billion under management focus on Asian securities. Scott Patterson, *Cocktail of Hedge Funds, Emerging Markets Is a Risky Mix*, *WALL ST. J.*, March 23, 2006.

58. *Hedge Fund Is Now A Meaningless Term: Going Back to Beta Suggests Trouble Generating Alpha*, *FINANCIAL TIMES*, August 18, 2005.

59. Jenny Anderson, *If Returns on Hedge Funds Decline, Shouldn't the Fees?*, *N.Y. TIMES*, August 26, 2005.

60. *Id.*

61. *Id.*



they typically focus on seeking outstanding performance, not low fees.<sup>62</sup>

#### IV. HEDGE FUND INVESTORS AND RETAILIZATION

Hedge funds began as private investment pools for very wealthy individuals and sophisticated institutional investors.<sup>63</sup> The hedge fund business continues to be built mostly on the strength of personal relationships and connections,<sup>64</sup> and the most successful hedge funds continue to court only the most high-end and wealthiest of investors who seek a complement to their core investment holdings.<sup>65</sup> Although hedge funds have been around at least since the 1950s,<sup>66</sup> during the bear market of 2000 through late 2002 the popularity of hedge funds grew very quickly.<sup>67</sup> Hedge funds began to become less exclusive, to the point where as of early 2006 there were approximately 8,000 hedge funds in the world, with well over \$1 trillion in assets under management.<sup>68</sup> Assets under management grew 30% in 2005 alone.<sup>69</sup> In contrast, in 1990 there were only around 600 hedge funds with less than \$40 billion in assets.<sup>70</sup> Today, hedge fund trading can account for as much as half of the daily volume of the New York Stock Exchange<sup>71</sup> and one-fifth of all U.S. stock-trading volume.<sup>72</sup> Even a former Chairman of the Commission, Richard C. Breeden, announced that he was launching his own hedge fund and raised \$500 million in less than a year.<sup>73</sup>

A good part of the explosion in hedge fund investment has been due to the fact that much less affluent investors have started to participate in a

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62. Jenny Anderson, *If Returns on Hedge Funds Decline, Shouldn't the Fees?*, N.Y. TIMES, August 26, 2005.

63. *Peering Into The Hedge Funds*, BUS. WK., October 3, 2005.

64. Riva D. Atlas, *Bayou Troubles Cast Shadow on Consultancy*, N.Y. TIMES, August 31, 2005.

65. Geraldine Fabrikant, *Hedge Funds Work for Yale, But Will They Work for You?*, N.Y. TIMES, November 27, 2005.

66. Alfred Jones launched the first hedge fund as early as 1949. *Hedge Fund Is Now a Meaningless Term: Going Back to Beta Suggests Trouble Generating Alpha*, FINANCIAL TIMES, August 18, 2005.

67. Gregory Zuckerman, Deborah Solomon, and Ian McDonald, *SEC Probes Idaho Hedge Fund*, WALL ST. J., October 8, 2005; Scott Patterson, *Race to Rate Hedge Funds Begins in Heavy Fog*, WALL ST. J., September 28, 2005.

68. Hedge Fund Research, Inc., available at [www.hedgefundresearch.com](http://www.hedgefundresearch.com); Gregory Zuckerman, Deborah Solomon, and Ian McDonald, *SEC Probes Idaho Hedge Fund*, WALL ST. J., October 8, 2005; Scott Patterson, *Race to Rate Hedge Funds Begins in Heavy Fog*, WALL ST. J., September 28, 2005.

69. *Peering Into The Hedge Funds*, BUS. WK., October 3, 2005; Michael Steinhardt, *Do You Really Need a Hedge Fund?*, WALL. ST. J., April 14, 2006.

70. Hedge Fund Research, Inc., available at [www.hedgefundresearch.com](http://www.hedgefundresearch.com).

71. Ben White, *As Hedge Funds Go Mainstream, Risk Is Magnified*, THE WASHINGTON POST, August 11, 2005.

72. Walter Hamilton, *Suit Tests SEC Rule on Hedge Funds*, LOS ANGELES TIMES, January 2, 2006.

73. Jenny Anderson, *Ex-Chairman of SEC Set to Start Hedge Fund*, N.Y. TIMES, September 13, 2005; Tiffany Kary, *Breeden's Activist Fund Has Raised \$500M*, DOW JONES, July 31, 2006.

meaningful way.<sup>74</sup> U.S. funds of hedge funds that are registered with the Commission as investment companies do not require that investors be accredited and accept investments as small as \$25,000.<sup>75</sup> Public pension funds, university endowments, charitable organizations, and retirement plans have increasingly been investing money into hedge funds, in some cases exposing unsophisticated investors to what amounts to a very risky investment strategy.<sup>76</sup> For example, the Virginia Retirement System has \$1.6 billion invested in hedge funds.<sup>77</sup> The California Public Employees' Retirement System recently doubled its hedge fund investment to \$2 billion.<sup>78</sup> Approximately 60% of foundations and endowments and 20% of pension funds that oversee worker retirement savings are now invested in hedge funds.<sup>79</sup> Many of these institutional investors are even pouring money into risky emerging market hedge funds.<sup>80</sup> Reasons for this trend include a desire for more diversification, generally low returns in other asset classes, and a herd's mentality that if others are investing in hedge funds there must be a good reason.<sup>81</sup>

This trend, known as the retailization of hedge funds, has created serious concerns that unsophisticated investors of modest or average means have money invested in vehicles they do not understand.<sup>82</sup> In order to avoid registration as investment companies under the Investment Company Act of 1940 ("Investment Company Act"), hedge funds must be private capital placements, and therefore cannot be advertised to the general public.<sup>83</sup> Therefore, hedge fund advisers typically secure investors through referrals from registered representatives and financial professionals.<sup>84</sup>

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74. M.P. Dunleavy, *Does "Hedge Fund" Mean Anything Anymore*, N.Y. TIMES, October 9, 2005; *Hedge Funds Could Face Increased Regulation*, LOS ANGELES TIMES, September 12, 2005.

75. Whitney Tilson, *Sensible Hedge Fund Regulation*, THE MOTLEY FOOL, April 11, 2003, Andy Serwer, *Where the Money's Really Made*, FORTUNE, March 31, 2003. Most funds of hedge funds are regulated by the Commission under the Investment Company Act of 1940.

76. *Peering Into The Hedge Funds*, BUS. WK., October 3, 2005; Ben White, *As Hedge Funds Go Mainstream, Risk Is Magnified*, THE WASHINGTON POST, August 11, 2005.

77. Ben White, *As Hedge Funds Go Mainstream, Risk Is Magnified*, THE WASHINGTON POST, August 11, 2005. Indeed, pension administrators, mandated to earn an 8% return or higher yearly so the fund will have enough cash to pay retirees, feel pressure to perform in the face of tepid returns from traditional stock and bond investments.

78. Ken Hoover, *Hedge Funds' Explosive Growth Spurs SEC's Registration Drive*, INVESTOR'S BUSINESS DAILY, January 26, 2006.

79. *Id.*

80. Scott Patterson, *Cocktail of Hedge Funds, Emerging Markets Is a Risky Mix*, WALL ST. J., March 23, 2006. For example, the California Public Employees' Retirement System recently allocated \$100 million to a Hong Kong firm that invests in hedge funds specializing in Asian emerging markets. *See id.*

81. *Growing Pains*, Economist.com, March 2, 2006.

82. Implications of the Growth of Hedge Funds, Staff Report to the U.S. Securities & Exchange Commission ("2003 Staff Hedge Fund Report"), October 2, 2003, at pp. 80-83, available at [www.sec.gov/news/extra/hedgestudyfacts.htm](http://www.sec.gov/news/extra/hedgestudyfacts.htm) and [www.sec.gov/news/studies/hedgefunds0903.pdf](http://www.sec.gov/news/studies/hedgefunds0903.pdf).

83. Eric Dash, *Have I Got a Fund for You*, N.Y. TIMES, September 30, 2005.

84. James Daw, *Charges Laid in Hedge Fund Scandal*, TORONTO STAR, October 6, 2005.

However, some hedge funds have begun to use television commercials to advertise their investment services to unsophisticated investors.<sup>85</sup> The retailization of hedge funds has created serious concerns that the hedge fund industry is too lightly regulated.<sup>86</sup>

## V. OTHER POTENTIAL CONCERNS ASSOCIATED WITH HEDGE FUNDS

Academics, commentators, and regulators have pointed out market risks and other potential concerns associated with the growth of hedge funds in addition to the changing nature of the average hedge fund investor. These concerns, which have prompted efforts to regulate hedge fund advisers, include, among others, excessive leverage and high concentration; conflicts of interest; hedge fund activism; and fraud.

### 1. Excessive Leverage and High Concentration

Some large hedge funds borrow so much money to finance their operations that an inability to meet their obligations due to sudden market reversals could endanger the financial markets. Some hedge funds also fail as a result of excessive leverage combined with a high concentration, which means that the fund invests all of its funds under management in very few positions while heavily borrowing for each dollar of invested capital.<sup>87</sup> For example, Long Term Capital Management ("LTCM") almost went out of business in 1998 because it had borrowed 100 times its capital to invest in derivative contracts worth \$1 trillion.<sup>88</sup> LTCM lost half of its equity and could not honor its agreements, an event initially prompted by the devaluation of the Russian Ruble.<sup>89</sup> A consortium of fourteen banks subsequently bailed-out LTCM to the tune of \$3.6 billion.<sup>90</sup> The Federal Reserve Board orchestrated the bail out to prevent panic in financial markets.<sup>91</sup> This is a good example of the damage hedge funds can inflict to our financial markets without proper market discipline and regulation. As more and more hedge funds compete to exploit the same market inefficiencies, managers are forced to take larger risks and borrow more money to make bigger investments, exposing these investments to a sudden

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85. Eric Dash, *Have I Got a Fund for You*, N.Y. TIMES, September 30, 2005.

86. Gary Weiss, *Hedge Funds v the SEC*, BUS. WK. online, March 3, 2003.

87. Whitney Tilson, *Sensible Hedge Fund Regulation*, THE MOTLEY FOOL, April 11, 2003.

88. Ben White, *As Hedge Funds Go Mainstream, Risk Is Magnified*, THE WASHINGTON POST, August 11, 2005.

89. *Id.*

90. Richard Wolffe, FINANCIAL TIMES, October 2, 1998.

91. *Id.*

credit crisis.<sup>92</sup>

Hedge funds rarely disclose how much they invest in each position, nor do they provide investors with a breakdown of the portfolio by asset type, market capitalization, and industry type.

## 2. Conflicts of Interest

The pervasive involvement of hedge funds in the securities industry has also started to create the types of conflicts of interest with which the Commission is typically concerned.<sup>93</sup> For example, Morgan Stanley recently announced that one of its newly elected mutual fund directors had a family connection to a hedge fund that had been a client of a Morgan Stanley subsidiary.<sup>94</sup> Such family connections may potentially impair directors' abilities to serve independently and honestly advocate for shareholders' interests.<sup>95</sup> Problems can also arise when the consultants who guide investors into particular hedge funds are affiliated with a fund of funds tied to that consultant's firm, and therefore give conflicted advice.<sup>96</sup> As highlighted in a Commission report documenting conflicts of interest involving pension-fund consultants, published in May 2005, consultants who steer investors into particular funds also sometimes require fund managers to pay a fee to attend conferences during which fund managers evaluate different hedge funds for their clients.<sup>97</sup> It is unclear whether consultants would discriminate against the hedge fund advisers who did not attend their gatherings, but the potential for a conflict of interest certainly seems to be present. As a final example, some of the largest hedge funds are reputed to pay very high commissions to brokers and, as a result, may receive advantages from these mutually beneficial relationships in the form of early tips from investment banks and brokers with respect to stock research and market-moving news.<sup>98</sup> Such conflicts of interest are almost inevitable and are likely to be scrutinized by regulators.

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92. Mark Gimein, *Is a Hedge Fund Shakeout Coming Soon?*, N.Y. TIMES, September 4, 2005.

93. *Morgan Director Has Ties to Hedge Fund*, N.Y. TIMES, August 24, 2005.

94. *Id.*

95. *Id.*

96. Lawrence C. Strauss, *Hedge Funds – Fund of Information: Conflicts: Big Problem or Big Hype?*, BARRON'S, August 29, 2005.

97. Staff Report Concerning Examinations of Select Pension Consultants, Report to the U.S. Securities & Exchange Commission by the Office of Compliance Inspections and Examinations, May 16, 2005, at 4, available at [www.sec.gov/news/studies/pensionexamstudy.pdf](http://www.sec.gov/news/studies/pensionexamstudy.pdf); Lawrence C. Strauss, *Hedge Funds – Fund of Information: Conflicts: Big problem or Big Hype?*, BARRON'S, August 29, 2005.

98. Alan Murray, *Hedge Funds Need to Open Up*, WALL. ST. J., April 5, 2006.

### 3. Hedge Fund Activism

Hedge funds are also increasingly known to represent a “new breed of shareholder activist,” using their equity in a number of large companies to effect changes in management or strategy that would increase the stock price and make their holdings more valuable.<sup>99</sup> For example, two hedge funds that control 25% of the stock of Bally Total Fitness Holding Corp. recently attempted to oust its CEO.<sup>100</sup> A powerful hedge fund also managed to pressure General Motors Corp. to slash its dividend, cut its executive pay, and name an advisor to the fund to the board of directors of General Motors.<sup>101</sup> A London-based hedge fund also staged a shareholder revolution against the CEO of Deutsche Borse, ultimately resulting in greater returns on its investment.<sup>102</sup> Some have warned that hedge funds engaging in this type of conduct are nothing more than corporate raiders, interested only in short-term profits instead of the long-term health of the companies in which they invest.<sup>103</sup> Others believe that hedge funds in fact often create positive changes at underperforming companies and correct the mispricing of securities.<sup>104</sup> In any event, this perceived increase in the influence of hedge funds in corporate affairs may be another reason for the inevitability of regulation.

### 4. Fraud

Regulation may also be beneficial to consumers if it assists the Commission in preventing fraud on the investing public. As described in detail in Section IX *infra*, many hedge funds and their advisers have recently been in the news after defrauding investors in a variety of ways.<sup>105</sup> For example, recent hedge fund scandals arose out of advisers’ attempts to cover up losses in trading which they thought they could earn back eventually.<sup>106</sup> In addition, advisers have used their hedge fund literature to mislead investors with respect to investment risks or performance disclosure.<sup>107</sup> Hedge fund managers have also misappropriated assets.<sup>108</sup>

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99. Susan Chandler, *Hedge Funds Put the Pressure On*, CHI. TRIB., January 27, 2006; Alan Murray, *Hedge Funds Are New Sheriffs of Boardroom*, WALL. ST. J., December 14, 2005.

100. Susan Chandler, *Hedge Funds Put the Pressure On*, CHI. TRIB., January 27, 2006.

101. *Attack of the Hungry Hedge Funds*, BUS. WK., February 20, 2006.

102. Growing Pains, Economist.com, March 2, 2006.

103. Susan Chandler, *Hedge Funds Put the Pressure On*, CHI. TRIB., January 27, 2006.

104. *Id.*

105. See Section IX, *infra*.

106. *SEC Scrutiny of Hedge Funds Is Good Start*, INVESTMENTS NEWS, September 26, 2005.

107. Alistair Barr, *NASD Probing Broker Hedge Fund Sales to Individuals*, DOW JONES BUSINESS NEWS, August 17, 2005.

This list is not meant to be exhaustive and there are many more potential risks associated with hedge funds' activities. For example, regulation can also be helpful to investors in the areas of portfolio valuation and pricing data.<sup>109</sup> Currently, hedge fund advisers have complete discretion to assign a valuation to their funds' positions<sup>110</sup> and could easily mislead investors through this procedure.

## VI. DOMESTIC HEDGE FUND ADVISER REGULATION

Hedge funds can potentially create huge risks to investors and to our economy as a whole, yet have essentially been able to operate outside of government oversight.<sup>111</sup> The comparatively light nature of regulation allowed hedge fund managers to operate in relative obscurity.<sup>112</sup> However, as more and more new hedge funds were launched in the past five years, with assets under management growing at a rapid pace, federal and state regulators have paid more attention to hedge funds and their advisers, in large part for the reasons previously discussed.<sup>113</sup>

### 1. Federal Regulation

#### A. Existing Regulation

All hedge funds and their advisers, whether registered with the Commission or not, have always been subject to the antifraud provisions of the securities laws, including Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder, and Section 206 of the

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108. SEC Press Release 2005-139, September 30, 2005, *available at* <http://www.sec.gov/news/press/2005-139.htm>.

109. Implications of the Growth of Hedge Funds, Staff Report to the U.S. Securities & Exchange Commission ("2003 Staff Hedge Fund Report"), October 2, 2003, at p. 99, *available at* [www.sec.gov/news/extra/hedgestudyfacts.htm](http://www.sec.gov/news/extra/hedgestudyfacts.htm) and [www.sec.gov/news/studies/hedgefunds0903.pdf](http://www.sec.gov/news/studies/hedgefunds0903.pdf). In that report, the staff recommended that the Commission "consider requiring, through rulemaking, that all registered investment companies that invest their assets in hedge funds, including registered [funds of hedge funds], have policies and procedures designed to ensure that funds and their boards value their interests in hedge funds in a manner consistent with the requirements of the Investment Company Act."

110. *Id.*

111. Stephen Labaton, *Judges Weigh Hedge Funds vs. the SEC*, N.Y. TIMES, December 10, 2005.

112. Jenny Anderson, *For Hedge Funds, Life Just Got a Bit More Complicated*, N.Y. TIMES, March 31, 2006.

113. Gregory Zuckerman, Deborah Solomon, and Ian McDonald, *SEC Probes Idaho Hedge Fund*, WALL ST J., October 8, 2005.

Investment Advisers Act of 1940 ("Advisers Act").<sup>114</sup> In addition, a number of hedge fund advisers are registered with the Commodities and Futures Trading Commission ("CFTC") as commodity pool operators.<sup>115</sup> In 2000, Congress exempted any CFTC-registered commodity trading adviser from investment adviser registration if its business does not consist primarily of acting as an investment adviser.<sup>116</sup> Moreover, industry analysts estimate that approximately half of all largest hedge fund advisers and 40% of all advisers to hedge funds based in the United States were already registered as investment advisers before any new rulemaking by the Commission in this area.<sup>117</sup> For example, many funds of hedge funds, which are sometimes marketed to people of modest or average wealth, are already registered with the Commission as closed-end investment companies under the investment Company Act.<sup>118</sup> More than 900 hedge fund advisers have registered with the Commission since the beginning of 2005.<sup>119</sup>

Although all hedge funds and their advisers are subject to the antifraud rules of the securities laws, some hedge funds avoid the reach of most of the securities laws entirely. For example, any entity that wishes to offer securities to the public must file a registration statement with the Commission under the Securities Act.<sup>120</sup> Hedge funds avoid this registration by making a non-public offering to "accredited investors" through Rule 506 of Regulation D, among other exemptions.<sup>121</sup>

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114. Jenny Anderson, *For Hedge Funds, Life Just Got a Bit More Complicated*, N.Y. TIMES, March 31, 2006.

115. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,064-65 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

116. 15 U.S.C. 80b-203(b)(6) (2000).

117. Mark Wilkinson, *U.S. Regulators Gear Up for Hedge Fund Oversight*, REUTERS NEWS, August 18, 2005; Walter Hamilton, *Suit Tests SEC Rule on Hedge Funds*, LOS ANGELES TIMES, January 2, 2006.

118. Geraldine Fabrikant, *Hedge Funds Work for Yale, But Will They Work for You?*, N.Y. TIMES, November 27, 2005; Lewis Braham, *Hedge Funds Go Wide*, BUS. WK., January 21, 2002.

119. Eleanor Laise and Rachel Emma Silverman, *Dissecting Hedge Fund Secrets*, WALL. ST. J., February 4, 2006.

120. Securities Act at 77f; See *SEC v. Murphy*, 626 F.2d 633, 639 (9th Cir. 1980); *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 686 (5th Cir. 1971). The Commission establishes a prima facie violation of Section 5 of the Securities Act by showing that: (1) no registration statement was filed or was in effect as to the security; (2) the defendants offered to sell or sold the security; and (3) interstate transportation or communications or the mails were used in connection with the offers or sales. See *SEC v. Continental Tobacco Co.*, 463 F.2d 137, 155 (5th Cir. 1972). Once the Commission has established a *prima facie* case, which does not require establishing scienter, the burden of proof shifts to the defendant to show that an exemption from registration was available. See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953); *SEC v. Murphy*, 626 F.2d 633, 641 (9th Cir. 1980). The courts have made it clear that exemptions from the registration requirements of the Securities Act are to be construed narrowly. See *Murphy*, 626 F.2d at 641.

121. 17 C.F.R. 230.506 (2004). Accredited investors are defined as individuals with a net worth of more than \$1 million, or income above \$200,000 in the last two years (or joint income with their spouse above \$300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, officers, or general partners of the hedge fund or its general partner; and

Similarly, hedge funds typically escape the reach of the Exchange Act by structuring themselves to fit within the definition of “traders” of securities rather than “brokers” or “dealers” who must register under the Act.<sup>122</sup> Most hedge funds also limit the number of equity holders to 499 to avoid Section 12(g) and Rule 12g-1 requiring that an issuer with at least 500 holders of record of equity security and assets in excess of \$10 million at the end of the most recent fiscal year register the equity securities under the Exchange Act.<sup>123</sup>

Hedge funds also do not have to register with the Investment Company Act as long as they only sell to “qualified investors”<sup>124</sup> or institutions, refrain from making a public offering, and have one hundred or fewer beneficial owners.<sup>125</sup>

Finally, hedge fund advisers escape the grasp of the Advisers Act by satisfying a safe harbor that allows them to treat each legal entity they advise (each fund) as a single client which allows them to invoke the small advisor exemption.<sup>126</sup> Under that exemption, investment advisers are exempt from registration as long as they have had fewer than fifteen clients during the preceding twelve months and do not hold themselves out to the public as investment advisers.<sup>127</sup> Because even the largest hedge fund advisers in the U.S. manage fewer than fifteen hedge funds, they are exempt from registration.<sup>128</sup>

## B. Commission’s Attempt to Regulate Hedge Fund Advisers

Hedge funds’ lack of transparency and clandestine operations, which have undoubtedly contributed to their mystique and exotic appeal, initially

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certain institutional investors, including: banks; savings and loan associations; registered brokers; dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies, and business trusts with more than \$500,000 in assets; and many employee benefit plans and trusts with more than \$5 million in assets. 17 C.F.R. 230.501(a) (2004).

122. 15 U.S.C. § 78a (2000). A trader is a person that buys and sells securities, either individually or in a trustee capacity, but not as part of a regular business. Entities that buy and sell securities for investment generally are considered traders, but not dealers. There is no registration requirement for traders. *Implications of the Growth of Hedge Funds*, Staff Report to the U.S. Securities & Exchange Commission (“2003 Staff Hedge Fund Report”), October 2, 2003, at p. 18, available at [www.sec.gov/news/extra/hedgestudyfacts.htm](http://www.sec.gov/news/extra/hedgestudyfacts.htm) and [www.sec.gov/news/studies/hedgefunds0903.pdf](http://www.sec.gov/news/studies/hedgefunds0903.pdf).

123. 15 U.S.C. § 78h (2000); 17 C.F.R. 240.12g-1 (2004).

124. Qualified investors are investors with at least \$5 million in investments. 15 U.S.C. § 80a2(a)(51) (2000).

125. 15 U.S.C. § 80a-3(c)(1) (2000).

126. Investment Advisers Act Section 203(b), 15 U.S.C. § 80b-3(b)(3) (2000).

127. 15 U.S.C. § 80b-3(b)(3) (2000).

128. *See Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*6 (D.C. Cir. June 23, 2006).



attracted only wealthy clients who chose them along with more traditional investment vehicles.<sup>129</sup> However, transparency is one of the strengths of the U.S. capital markets, and it attracts investors from around the world.<sup>130</sup> In response to the rapid growth of the hedge fund industry, coupled with a perceived lack of transparency in this industry and an increase in hedge fund fraud, the Commission directed its staff to conduct a study of hedge funds.<sup>131</sup> The report, issued in late 2003, cited concerns that included the rapid growth of hedge funds as well as many of the issues discussed above, including the increasing number of hedge fund fraud enforcement cases.<sup>132</sup> The report noted that hedge fund advisers have been heavily involved in arbitrage strategies such as market timing of mutual fund shares.<sup>133</sup> As a result of the report's findings, in July 2004, the Commission proposed a new rule requiring hedge fund advisers to count each investor in a hedge fund, rather than just the hedge fund itself, as a "client" for purposes of the private investor exemption.<sup>134</sup>

In October 2004, as a result of this study and the staff's recommendations, the Commission, in a 3-2 vote under former Commission Chairman William Donaldson, adopted Rule 203(b)(3)-2 under the Advisers Act, requiring most hedge fund advisers to register as investment advisers (the "Hedge Fund Rule").<sup>135</sup> Commissioners Paul Atkins and Cynthia Glassman dissented.<sup>136</sup> On December 2, 2004, the Commission issued its release on the Hedge Fund Rule and amended the Advisers Act rule to include a number of hedge fund advisers within its

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129. *The New Money Men*, THE ECONOMIST, February 17, 2005.

130. Floyd Norris, *Are These Hedge Fund Results Real?*, N.Y. TIMES, April 21, 2006.

131. Implications of the Growth of Hedge Funds, Staff Report to the U.S. Securities & Exchange Commission ("2003 Staff Hedge Fund Report"), October 2, 2003, at p. vii, 2003, available at [www.sec.gov/news/extra/hedgestudyfacts.htm](http://www.sec.gov/news/extra/hedgestudyfacts.htm) and [www.sec.gov/spotlight/hedgefund.htm](http://www.sec.gov/spotlight/hedgefund.htm).

132. Implications of the Growth of Hedge Funds, Staff Report to the U.S. Securities & Exchange Commission ("2003 Staff Hedge Fund Report"), October 2, 2003, at pp. 72-87, available at [www.sec.gov/news/extra/hedgestudyfacts.htm](http://www.sec.gov/news/extra/hedgestudyfacts.htm) and [www.sec.gov/spotlight/hedgefund.htm](http://www.sec.gov/spotlight/hedgefund.htm).

133. Implications of the Growth of Hedge Funds, Staff Report to the U.S. Securities & Exchange Commission ("2003 Staff Hedge Fund Report"), October 2, 2003, at p. 35, available at [www.sec.gov/news/extra/hedgestudyfacts.htm](http://www.sec.gov/news/extra/hedgestudyfacts.htm) and [www.sec.gov/spotlight/hedgefund.htm](http://www.sec.gov/spotlight/hedgefund.htm).

134. Registration Under the Advisers Act of Certain Hedge Fund Advisers, (Release No. IA-2266, Jul. 20, 2004), available at [www.sec.gov/rules/final/ia-2266.htm](http://www.sec.gov/rules/final/ia-2266.htm).

135. Speech by SEC Chairman: SEC Open Meeting: Registration of Hedge Fund Advisers, October 26, 2004, available at [www.sec.gov/news/speech/spch102604whd.htm](http://www.sec.gov/news/speech/spch102604whd.htm); see also Ben White, *As Hedge Funds Go Mainstream, Risk Is Magnified*, THE WASHINGTON POST, August 11, 2005; *US Court to Hear Challenge to SEC Hedge Fund Rule*, REUTERS, December 8, 2005. On June 23, 2006, the U.S. Court of Appeals for the District of Columbia Circuit vacated the Hedge Fund Rule. See *Goldstein v. SEC*, No. 04-1434 (D.C. Cir. June 23, 2006), discussed further *supra* in Section VI.I.C.

136. Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,089 (Dec. 10, 2004) (Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm); Alistair Barr, *SEC Said to Struggle Ahead of Hedge Fund Registration*, DOW JONES, September 30, 2005. Federal Reserve Board Chairman Alan Greenspan also opined that the federal government ought not to regulate hedge funds. *Greenspan Against Government Regulation of Hedge Funds*, HEDGE FUND STREET, May 5, 2005.

reach.<sup>137</sup> When Chairman Christopher Cox joined the Commission he announced that he planned to implement the Hedge Fund Rule “exactly as adopted.”<sup>138</sup>

Under the Hedge Fund Rule, Rule 203(b)(3)-2, and related amendments to Rule 203(b)(3)-1 and Form ADV, the Commission interpreted the word “client” under the Advisers Act to mean each individual investor of a hedge fund, as opposed to the fund itself.<sup>139</sup> Under this interpretation, many hedge fund managers had to register as “investment advisers” because they offered investment advice on the value of securities for a fee to at least fifteen “clients.”<sup>140</sup> Therefore, under the Hedge Fund Rule, investment advisers could no longer rely on the traditional private adviser exemption from registration requirement if they had advised a hedge fund that had more than fourteen investors in the preceding twelve months.<sup>141</sup> In adopting the Hedge Fund Rule, the Commission noted that Congress did not appear to have addressed whether an adviser must count an investor in a pooled investment vehicle as a client for purposes of Section 203(b)(3).<sup>142</sup> The Commission concluded that “looking through” the advised entity was consistent with the broad remedial purposes of the Advisers Act.<sup>143</sup> The Commission noted that, otherwise, an adviser with fifteen clients and \$100 million in assets under management could take those assets and simply move them into a hedge fund to claim only one client and therefore withdraw from registration under the Advisers Act, an undesirable outcome.<sup>144</sup>

Under the Hedge Fund Rule, all advisers to a “private fund”<sup>145</sup> with at

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137. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,059 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

138. Anuj Gangahar, *U.S. Politician Backs Strict Hedge Fund Rules*, FINANCIAL NEWS, October 23, 2005; John Berlau, *Hedge Funds Today: Who Is Watching the Watchdog?*, WALL ST. J., December 9, 2005.

139. Rule 203(b)(3)-2; Stephen Labaton, *Judges Weigh Hedge Funds vs. the SEC*, N.Y. TIMES, December 10, 2005; Kevin Drawbaugh, *US Court Questions Basics of SEC Hedge Fund Rule*, REUTERS, December 9, 2005.

140. John Berlau, *Hedge Funds Today: Who Is Watching the Watchdog?*, WALL ST. J., December 9, 2005; Stephen Labaton, *Judges Weigh Hedge Funds vs. the SEC*, N.Y. TIMES, December 10, 2005.

141. Norman Arnoff and Stephen Wexler, *On the Radar Screen: The Hedge Fund Adviser Rule; Other Considerations*, N.Y. LAW JOURNAL, December 29, 2005.

142. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,067 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

143. *Id.*

144. *Id.* The Commission noted that the “Act’s objectives would be substantially undermined if an adviser with more than fifteen clients could evade its registration obligation through the simple expedient of having those clients invest in a limited partnership or similar fund vehicle—which the adviser would thereafter count as a single client.” *Id.* at 72,068.

145. Defined in Rule 203(b)(3) of the Advisers Act. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,073-4 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

least \$30 million in assets<sup>146</sup> and fifteen or more clients were required to be registered with the Commission effective February 1, 2006.<sup>147</sup> First, a fund will not be a "private fund" unless it is a company that would be subject to regulation under the Investment Company Act but for the exception, from the definition of "investment company," provided in either section 3(c)(1) (a "3(c)(1) fund") or section 3(c)(7) (a "3(c)(7) fund") of such Act.<sup>148</sup> Second, a company will be a private fund only if it permits investors to redeem their interests in the fund within two years of purchasing them.<sup>149</sup> Limiting this period to two years would allow the Commission to require registration of most hedge fund advisers while at the same time exclude advisers that manage only private equity funds and venture capital funds that require investors to make long-term investments to capital.<sup>150</sup> Finally, a company will be a private fund only if interests in it are offered based on the investment advisory skills, ability, or expertise of the investment adviser.<sup>151</sup>

This registration requirement extended to offshore advisers who raise money from U.S. investors.<sup>152</sup> By February 1, 2006, each adviser required

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146. In determining the amount of assets it has under management a hedge fund adviser whose principal office and place of business is in the United States must include the total value of securities portfolios in its assets under management. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,070 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

147. Rule 275.203(b)(3)-2(a), Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,077 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm); Mark Wilkinson, *U.S. Regulators Gear Up for Hedge Fund Oversight*, REUTERS NEWS, August 18, 2005; *SEC Charges Hedge Fund with Fraud*, REUTERS NEWS, August 24, 2005.

148. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,073-4 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

149. *Id.* Walter Hamilton, *Suit Tests SEC Rule on Hedge Funds*, LOS ANGELES TIMES, January 2, 2006. In response to this requirement, and to avoid regulation, many funds have changed their lock-up periods to two years or more. It is unclear how many hedge funds have extended their lock-up periods to avoid regulation. Jeff Benjamin, *Hedge Funds Exploit a Loophole; Some Funds Extend Lockup*, INVESTMENT NEWS, September 26, 2005. Commentators had predicted this response to regulation prior to the Hedge Fund Rule's adoption. See Comment Letter of the Greenwich Roundtable (September 15, 2004).

150. The Commission noted that venture capital funds, which typically invest in closely held companies and have a long-term investment horizon, have not been involved in fraudulent schemes to the extent that hedge funds have and therefore the Commission determined not to focus its examination resources in this area at this time. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,074 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

151. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,073-4 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

152. Deborah Brewster, *SEC Considers Easing Its New Hedge Fund Registration Rules*, FINANCIAL TIMES, October 27, 2005. Advisers who manage publicly offered funds overseas are not required to register under the securities laws provided they are regulated as a public investment company by the laws of a country other than the United States and their offices are overseas. See Registration Under the

to register under the Hedge Fund Rule had to have in place all policies and procedures required under the registration process.<sup>153</sup> For example, each adviser had to designate a chief compliance officer and comply with the rule for custody of client funds and securities.<sup>154</sup> Once hedge fund advisers are registered, as part of the registration process they also have to submit to examinations,<sup>155</sup> adopt codes of ethics setting forth expected standards of conduct,<sup>156</sup> and maintain certain books and records.<sup>157</sup> Among other things, the Commission's examination staff may review the firm's internal controls and procedures and examine the adequacy of procedures for valuing client assets.<sup>158</sup> In addition, the Commission may use examinations to ensure that performance claims in marketing materials are accurate.<sup>159</sup>

Under Rule 203-1, all persons applying for investment adviser registration have to file Form ADV with the Commission, which identifies individuals associated with the advisers and includes information about the number of hedge funds managed by the advisers, the amount of assets held in the funds, the number of persons employed by the advisers, other business activities they conduct, and the identity of persons that control or are affiliated with the firms.<sup>160</sup> Rule 204-1 requires each registered adviser

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Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,072 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279).

153. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,077 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), *available at* [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

154. Rules 206(4)-7 and 206(4)-2 of the Advisers Act; Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,079 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), *available at* [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm). The compliance officer can have other responsibilities, avoiding the need to hire someone specifically for that position.

155. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,061 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), *available at* [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

156. Rule 204A-1 of the Advisers Act; Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,084 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), *available at* [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

157. Rule 204-2 of the Advisers Act; Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,084 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), *available at* [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm); Mark Wilkinson, *U.S. Regulators Gear Up for Hedge Fund Oversight*, REUTERS NEWS, August 18, 2005; *SEC Adopts "Risk-Based" Approach to Hedge Industry*, REUTERS, September 14, 2005.

158. Amended Rule 203(b)(3)-1(d) of the Advisers Act; Rule 206(4)-2 of the Advisers Act, Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,061 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), *available at* [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

159. Under Rule 204-2(a)(16), a registered investment adviser that makes claims concerning its performance track record must keep all records and documents necessary to demonstrate the accuracy of the marketed performance. The supporting records must be retained for five years after the performance information is last used by the fund.

160. Rule 203-1 of the Advisers Act; Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,079 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), *available at* [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

to file amendments to Form ADV at least annually.<sup>161</sup> Advisers also have to disclose any disciplinary actions filed against them.<sup>162</sup> The regulation process permits the Commission to institute a proceeding to determine whether to deny registration of an adviser if individuals associated with the adviser or the adviser itself have been convicted of a felony or have a disciplinary record subjecting them to disqualification.<sup>163</sup> All other rules previously applicable to investment advisers, such as certain limitations on performance fees and rules governing advertising and cash solicitations are also applicable to all hedge fund advisers who have registered with the Commission.<sup>164</sup>

Despite the hedge fund industry's strong opposition to regulation, many commentators have concluded that such regulation would give the investment community more faith and confidence.<sup>165</sup> As former Commissioner Roel Campos and others have stated, the Hedge Fund Rule was not at all heavy-handed and only constituted a first step in the Commission's attempts to restore investor confidence in this area.<sup>166</sup> For example, registration would not have required hedge fund advisers to provide performance statistics.<sup>167</sup> The Hedge Fund Rule also would not have required hedge fund advisers to follow or avoid any particular investment strategies, including short-selling, or, to meet diversification requirements.<sup>168</sup> Nor would it have greatly limited what hedge fund managers can charge in performance fees.<sup>169</sup> Indeed, hedge fund advisers may continue to charge

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161. Rule 204-1 of the Advisers Act; Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,083 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

162. 17 C.F.R. 275.203(1); 17 C.F.R. 275.204-1 (2004); *Hedge Fund Sleuths*, BUS. WK., November 21, 2005.

163. Rule 206(4)-4 of the Advisers Act; Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,063 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm); see Section 203(c)(2)(B) of the Advisers Act and Item 11 of Part 1 of Form ADV which requires applicants for registration as an investment adviser to report felonies and other disciplinary events that occurred in the past ten years; Investment Company Institute, *The Differences Between Mutual Funds and Hedge Funds*, March 2005.

164. Rules 206-(4)-1 and 206(4)-3. Norman Arnoff and Stephen Wexler, *On the Radar Screen: The Hedge Fund Adviser Rule; Other Considerations*, N.Y. LAW JOURNAL, December 29, 2005.

165. *Hedge Fund Rules Ease Minds, Raise Questions*, REUTERS, September 9, 2005.

166. SEC Adopts "Risk-Based" Approach to Hedge Industry, REUTERS, September 14, 2005; *SEC Scrutiny of Hedge Funds Is Good Start*, INVESTMENTS NEWS, September 26, 2005; Walter Hamilton, *Suit Tests SEC Rule on Hedge Funds*, LOS ANGELES TIMES, January 2, 2006.

167. Robert Pozen, *Reporting Standards For Hedge Funds Must Be Raised*, FINANCIAL TIMES, January 12, 2006.

168. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,060 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm). In contrast, mutual funds must meet diversification requirements. Indeed, in the case of mutual funds, the funds, as well as their advisers, are registered with the Commission. Jenny Anderson, *For Hedge Funds, Life Just Got a Bit More Complicated*, N.Y. TIMES, March 31, 2006.

169. Jenny Anderson, *For Hedge Funds, Life Just Got a Bit More Complicated*, N.Y. TIMES, March 31, 2006.

clients a performance fee as long as clients have a net worth of at least \$1.5 million or at least \$750,000 under management.<sup>170</sup> Importantly, the Hedge Fund Rule also would not have required hedge fund advisers to disclose their portfolio holdings, nor interfere with their desire or ability to leverage their portfolio.<sup>171</sup> At a minimum, however, the Hedge Fund Rule would have given the Commission some oversight concerning hedge fund adviser activity and a better chance to detect fraudulent conduct at an early stage.<sup>172</sup> By enabling the staff of the Commission to conduct examinations of hedge fund advisers, regulation may have resulted in early detection of compliance problems and practices that may lead to investor harm.<sup>173</sup>

A Commission spokesman stated that 714 hedge fund advisers had registered with the Commission by the deadline of February 1, 2006.<sup>174</sup> By July 2006, as many as 1,250 hedge fund advisers had registered with the Commission.<sup>175</sup> Approximately a quarter of all investment advisers registered with the Commission as of July 2006 managed a hedge fund.<sup>176</sup>

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170. Rule 205-3; *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*12 (D.C. Cir. June 23, 2006). A “qualified client” under rule 205-3 is: (i) A natural person who or a company that immediately after entering into the contract has at least \$750,000 under the management of the investment adviser; (ii) A natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either: (A) Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than \$1,500,000 at the time the contract is entered into; or (B) Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 [15 U.S.C. 80a-2(a)(51)(A)] at the time the contract is entered into; or (iii) A natural person who immediately prior to entering into the contract is: (A) An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or (B) An employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months. Rule 205-3(d)(1).

171. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,060 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

172. Remarks of Commissioner Roel C. Campos before the SIA-Hedge Fund Conference, September 14, 2005, available at [www.sec.gov/news/speech/spch091405rcc.htm](http://www.sec.gov/news/speech/spch091405rcc.htm); Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,080 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

173. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,080 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

174. Becky Yerak, *At Declaration Day, Hedge Funds Circumvent Rules*, CHI. TRIB., February 1, 2006.

175. Mark Braswell, *Not Quite Dead Yet SEC Hedge Fund Manager Rule in Limbo*, MONDAQ BUSINESS BRIEFING, July 10, 2006.

176. Jeremy Gray and Holly Yeager, *Hagel in Call for Hedge Fund Hearings*, Financial Times, June 27, 2006.

### C. *Goldstein v. SEC*

A hedge fund manager, Phillip Goldstein, his firm, Opportunity Partners LLC, and the firm's general partner, Kimball & Winthrop, an investment advisory firm, filed suit against the Commission in December 2004, arguing that the Commission lacked any power to regulate the hedge fund adviser industry and that only Congress may change the Advisers Act.<sup>177</sup> Since at the time Congress passed the Advisers Act hedge funds did not exist, it is unclear whether it would have viewed the hedge fund or the hedge fund's investors as the "client," a term not defined in the statute.<sup>178</sup>

A three-judge panel of the U.S. Court of Appeals for the District of Columbia Circuit heard arguments in this case on December 9, 2005.<sup>179</sup> On June 23, 2006, the U.S. Court of Appeals for the District of Columbia Circuit vacated and remanded the Hedge Fund Rule.<sup>180</sup> The court held that the Commission's interpretation of the word "client" was "outside the bounds of reasonableness," "arbitrary," and inconsistent with Congressional intent.<sup>181</sup> The court went so far as to state that the Hedge Fund Rule came "close to violating the plain language" of the Advisers Act.<sup>182</sup>

The court stated that the client of an adviser to a hedge fund is the fund itself, not the fund's investors.<sup>183</sup> Indeed, the "adviser owes fiduciary duties to the fund, not to the fund's investors."<sup>184</sup> The court noted that the very definition of "investment adviser" explicitly states that it is "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling

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177. See *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760 (D.C. Cir. June 23, 2006); Siobhan Hughes, *Court Sets Hearing On Suit Over SEC Hedge Fund Rule*, DOW JONES NEWSWIRES, October 4, 2005; Stephen Labaton, *Judges Weigh Hedge Funds vs. the SEC*, N.Y. TIMES, December 10, 2005; Walter Hamilton, *Suit Tests SEC Rule on Hedge Funds*, LOS ANGELES TIMES, January 2, 2006.

178. See *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*13 (D.C. Cir. June 23, 2006); Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,067 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

179. Siobhan Hughes, *Court Sets Hearing On Suit Over SEC Hedge Fund Rule*, DOW JONES NEWSWIRES, October 4, 2005.

180. See *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*32 (D.C. Cir. June 23, 2006).

181. See *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*18, \*22, \*32 (D.C. Cir. June 23, 2006).

182. See *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*23 (D.C. Cir. June 23, 2006).

183. *Id.*

184. See *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*21-24 (D.C. Cir. June 23, 2006). The Court noted that an adviser is typically "concerned with the fund's performance, not with each investor's financial condition."

securities.”<sup>185</sup> Because an investor in a private fund does not receive any advice *directly* from the adviser, in contrast to the fund itself, it follows that the investor is not the *client*.<sup>186</sup> The court also pointed out what it perceived to be contradictions in the Commission’s interpretation. For example, the Commission previously adopted a safe harbor from registration for general partners of limited partnerships, enabling them to count the partnership as a single client for the purposes of Section 203 as long as they provided advice to a collective investment vehicle based on the investment goals of the limited partners as a group, an exemption that was subsequently extended to corporations, limited liability companies, and business trusts.<sup>187</sup> The court noted that the Hedge Fund Rule appeared to “carve out an exception from this safe harbor solely for investment entities that have fewer than one hundred-one but more than fourteen investors,” an arbitrary determination.<sup>188</sup> Although the court understood the Commission’s desire to regulate hedge funds, it ruled that this goal could not be accomplished “by a manipulation of meaning.”<sup>189</sup>

In response to the decision, Commission Chairman Cox issued a statement stating that it “requires that we reevaluate the agency’s approach to hedge fund activity.”<sup>190</sup> In public statements, outgoing Commissioner Cynthia Glassman suggested that the Commission adopt a “notice and filing” system, instead of the Hedge Fund Rule, that would require hedge fund advisers to provide the Commission with information about their financial background, their auditor, the number of investors in the fund, and the value of assets under management.<sup>191</sup>

On July 25, 2006, the U.S. Senate Committee on Banking, Housing, and Urban Affairs held a hearing on the regulation of hedge funds.<sup>192</sup> Chairman Cox testified that the existing regulatory regime was inadequate in the context of hedge funds.<sup>193</sup> “We have been forced back to the drawing board to devise a workable means of acquiring even basic census

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185. See *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*18 (D.C. Cir. June 23, 2006) (citing 15 U.S.C. § 80b-2(11)).

186. See *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*19 (D.C. Cir. June 23, 2006).

187. See *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*29-30 (D.C. Cir. June 23, 2006).

188. See *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*29-32 (D.C. Cir. June 23, 2006).

189. See *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*27 (D.C. Cir. June 23, 2006).

190. *Investment Adviser: Bump in Road Hits SEC Hedge Rules*, INVESTMENT ADVISER, July 10, 2006.

191. Ron Orol, *Glassman Urges SEC Action*, TheDeal.com, July 6, 2006.

192. Liz Moyer, *Hedge Fund Heaven*, FORBES, July 25, 2006; *SEC Chief to Seek New Hedge Fund Rules*, AP, July 25, 2006.

193. The full testimony is available on the SEC website at <http://www.sec.gov/news/testimony/2006/ts072506cc.htm>. *SEC Chief to Seek New Hedge Fund Rules*, AP, July 25, 2006.



data that would be necessary to monitor hedge fund activity,” Cox stated.<sup>194</sup> He also testified that: “[t]he potential for retail investors to be harmed by hedge-fund risk” remained a serious concern.<sup>195</sup> Chairman Cox said he would recommend that the Commission adopt a new antifraud rule for hedge funds that would establish serious obligations to investors on the part of fund managers and at the same time meet the legal objections of the D.C. Circuit.<sup>196</sup>

On August 7, 2006, Chairman Cox issued a statement in which he announced that the Commission would not seek en banc review of the decision of the U.S. Court of Appeals.<sup>197</sup> He stated that the Commission would announce “an agenda of rulemaking and staff guidance to address the legal consequences from the invalidation of the rule.”<sup>198</sup> “Among the significant new proposals will be a new anti-fraud rule under the Investment Advisers Act that would have the effect of ‘looking through’ a hedge fund to its investors. This would reverse the side-effect of the Goldstein decision that the anti-fraud provisions of the Act apply only to ‘clients’ as the court interpreted that term, and not to investors in the hedge fund.”<sup>199</sup>

Although the effect of the court’s decision is to render the Hedge Fund Rule unenforceable, the currently registered advisers remain subject to the statutory provisions applicable to registered advisers under the Advisers Act. Hedge fund advisers can elect to deregister by filing a Form ADV-W with the Commission to withdraw their registration.<sup>200</sup> However, commentators have suggested that remaining registered could be a marketing advantage, presumably because investors would gain confidence from the oversight the registration system provides.<sup>201</sup>

## 1. New Antifraud Rule Under Advisers Act

On July 11, 2007, the Commission unanimously adopted new Rule 206(4)-8 under the Advisers Act, a new antifraud rule designed to protect

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194. Liz Moyer, *Hedge Fund Heaven*, FORBES, July 25, 2006.

195. *SEC Chief to Seek New Hedge Fund Rules*, AP, July 25, 2006.

196. Liz Moyer, *Hedge Fund Heaven*, FORBES, July 25, 2006; *SEC Chief to Seek New Hedge Fund Rules*, AP, July 25, 2006.

197. Statement of Chairman Cox Concerning the Decision of the U.S. Court of Appeals in *Phillip Goldstein, et al. v. SEC*, SEC Press Release 2006-135, August 7, 2006, available at [www.sec.gov/news/press/2006/2006-135.htm](http://www.sec.gov/news/press/2006/2006-135.htm).

198. *Id.*

199. *Id.*

200. 17 C.F.R. 275.203-2; Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,083 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

201. Jenny Anderson, *For Time Being, Hedge Funds Stay Registered*, N.Y. TIMES, June 27, 2006; Jeremy Grant, *Hedge Fund Advisers Move to SEC Register*, FINANCIAL TIMES, August 1, 2006.

investors in pooled investment vehicles (“new antifraud rule”).<sup>202</sup> The new antifraud rule applies to investment advisers of hedge funds, private equity funds, venture capital funds, and mutual funds.<sup>203</sup> Importantly, the new antifraud rule applies to all investment advisers to pooled investment vehicles, whether registered under the Advisers Act or not.<sup>204</sup> The new antifraud rule makes it a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser to a pooled investment vehicle to make false or misleading statements to, or otherwise to defraud, investors or prospective investors in that pool.<sup>205</sup> Under the new antifraud rule, a pooled investment vehicle includes any investment company and any company that would be an investment company but for the exclusions in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.<sup>206</sup> The new antifraud rule took effect thirty days after publication in the Federal Register.<sup>207</sup>

## 2. State Regulation

In addition to the protection offered under federal law, states may also enact their own regulatory framework.<sup>208</sup> Recently, the state attorney general for Connecticut called for greater regulation of the hedge fund industry, and stated that state authorities should assist the Commission in regulating this industry.<sup>209</sup> Individual states’ involvement in antifraud enforcement, when not duplicative of the Commission’s role, should be encouraged.<sup>210</sup> Many states, such as California and Texas, actively seek to

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202. Release No. 2007-133, available at <http://www.sec.gov/news/press/2007/2007-133.htm>, Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,757 (August 3, 2007) (Release No. IA-2628), available at [www.sec.gov/rules/final/ia-2628.htm](http://www.sec.gov/rules/final/ia-2628.htm).

203. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,758 (August 3, 2007) (Release No. IA-2628), available at [www.sec.gov/rules/final/ia-2628.htm](http://www.sec.gov/rules/final/ia-2628.htm).

204. *Id.*

205. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,760-61 (August 3, 2007) (Release No. IA-2628), available at [www.sec.gov/rules/final/ia-2628.htm](http://www.sec.gov/rules/final/ia-2628.htm).

206. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,758 (August 3, 2007) (Release No. IA-2628), available at [www.sec.gov/rules/final/ia-2628.htm](http://www.sec.gov/rules/final/ia-2628.htm).

207. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,756 (August 3, 2007) (Release No. IA-2628), available at [www.sec.gov/rules/final/ia-2628.htm](http://www.sec.gov/rules/final/ia-2628.htm).

208. Jenny Anderson, *For Hedge Funds, Life Just Got a Bit More Complicated*, N.Y. TIMES, March 31, 2006.

209. Anuj Gangahar, *U.S. Politician Backs Strict Hedge Fund Rules*, FINANCIAL NEWS, October 23, 2005. The State of Connecticut formed a task force to evaluate disclosure requirements, conflicts of interest, government enforcement, fraud penalties, and auditing requirements, and to make recommendations on state and federal regulation. *Id.*; Carol E. Curtis, *No Lifeguard on Duty*, SECURITIES INDUSTRY NEWS, March 20, 2006.

210. Marc I. Steinberg, *The Emergence of State Securities Laws. Partly Sunny Skies for Investors*, 61 U. CIN. L. REV. 395 (1993).

protect investor interests.<sup>211</sup>

## VII. OPPOSITION TO DOMESTIC HEDGE FUND ADVISER REGULATION

Critics of hedge fund adviser regulation have advanced a number of arguments against the Hedge Fund Rule. This section offers a very general summary of their main arguments.<sup>212</sup>

The first argument against federal regulation is based on the contention that the Commission simply lacks jurisdiction over hedge fund advisers.<sup>213</sup> Indeed, as previously discussed, without Congressional approval, the Commission may not interpret the word “client” under the Advisers Act to mean each individual investor of a hedge fund, as opposed to the fund itself.<sup>214</sup>

A second argument in support of a view that hedge fund advisers should not be regulated is a pragmatic one: that regulating them will simply drive them underground.<sup>215</sup> In other words, this argument is based on the idea that overregulation in the U.S. markets will result in hedge fund advisers relocating offshore, where they would face less regulatory scrutiny.<sup>216</sup> Indeed, U.S. hedge fund advisers already are competing with offshore hedge funds that typically benefit from more lenient regulatory controls and attractive tax regimes.<sup>217</sup>

A related, slightly different argument is that regulation requirements will result in less investment choices for U.S. investors and deter innovative investment strategies.<sup>218</sup> Many non-U.S. advisers might shy away from offering their funds to U.S. residents if they were required to

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211. Marc I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 61 U. CIN. L. REV. 395, 398-99 (1993).

212. A more detailed discussion of the arguments against regulation is beyond the scope of this article. For a good overview of these arguments, see Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,089-92 (Dec. 10, 2004) (Release No. 1A-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

213. See discussion of *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760 (D.C. Cir. June 23, 2006) at Section VI.1 C., *supra*.

214. See *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760, at \*22, \*32 (D.C. Cir. June 23, 2006).

215. Comment Letter of the International Swaps and Derivatives Association (September 15, 2004) (registration will force hedge funds offshore and reduce the market as a whole).

216. Barney Jopson and Peter Thal Larsen, *International Watchdog to Probe Risk From Hedge Funds*, FINANCIAL TIMES, October 6, 2005; Judith Burns, *US Regulators Favor Scrutiny of Hedge Funds For Now*, DOW JONES, May 16, 2006.

217. Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 J. ECON. PERSP. 189, 190 (1999).

218. Deborah Brewster, *SEC Considers Easing Its New Hedge Fund Registration Rules*, FINANCIAL TIMES, October 27, 2005; Comment Letter of the U.S. Chamber of Commerce (September 15, 2004) (advisers might avoid innovative strategies to avoid regulatory scrutiny).

register with the Commission.<sup>219</sup>

A third main argument against regulation is based on the observation that the Commission's oversight of mutual funds, even without the added burden of hedge fund adviser regulation, has only yielded mixed results.<sup>220</sup> Critics of regulation also argue that registration would not have prevented the securities violations that led to calls for hedge fund adviser regulation.<sup>221</sup>

Other critics, such as the National Venture Capital Association, object to regulation on a fourth ground.<sup>222</sup> They argue that the Hedge Fund Rule was too broad and as defined would have applied to most venture capital and private equity funds.<sup>223</sup>

Others objected to the Hedge Fund Rule on the ground that it was overly burdensome and would have unduly increased administrative workload and costs, which would have been passed on to investors.<sup>224</sup>

Another argument against regulation is that it would have indirectly attracted inexperienced investors into the hedge fund industry.<sup>225</sup> Indeed, unsophisticated investors could have been lulled into a false sense of security that the regulation of hedge fund advisers would have eliminated risk and guaranteed performance.<sup>226</sup>

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219. Deborah Brewster, *SEC Considers Easing Its New Hedge Fund Registration Rules*, FINANCIAL TIMES, October 27, 2005. Commentators have written about a frequently-expressed sentiment abroad that the U.S. is trying to impose its regulatory regime around the world. Michael Schroeder and Silvia Ascarelli, *Global Cop – New Role for SEC: Policing Companies Beyond U.S. Borders*, WALL ST. J., July 30, 2004 (reporting “U.S. regulatory imperialism,” a new term that surfaced in European circles around the time of the Royal Dutch/Shell Group, Parmalat, and Vivendi Universal investigations).

220. *Peering Into The Hedge Funds*, BUS. WK., October 3, 2005.

221. Critics claim that many advisers implicated in fraud had insufficient assets under management to be eligible for SEC registration under the Hedge Fund Rule and, to the extent that they did meet the minimum asset requirement for registration, would nevertheless have perpetrated their fraudulent schemes. Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,092 (Dec. 10, 2004) (Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

222. John Berlau, *Hedge Funds Today. Who Is Watching the Watchdog?*, WALL ST. J., December 9, 2005.

223. *Id.*

224. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279), Dissenting opinion of Commissioners Cynthia A. Glassman and Paul S. Atkins at 72,094-96; The Heritage Foundation, *Regulation in Brief. Hedge Fund Regulation*, April 19, 2004; Comment Letter of Davis, Polk & Wardwell (September 15, 2004) (noting that the costs of registration and compliance are substantial and will be passed on to investors).

225. Dane Hamilton, *Hedge Fund Registration No Panacea for Risk: Scholes*, REUTERS, September 30, 2005.

226. Nobel Prize economist and Stanford Business School Professor Myron Scholes suggested this possibility in a speech to investors in September 2005. Dane Hamilton, *Hedge Fund Registration No Panacea for Risk: Scholes*, REUTERS, September 30, 2005. As the majority of the Commission pointed out, however, such an argument could be used against any regulation of the securities laws. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72080

Some critics of regulation attack its purported necessity and deny the existence of a trend towards hedge fund retailization, claiming that only 1% of all funds invested in U.S. pension funds are in fact invested in hedge funds.<sup>227</sup> They also point out that to the extent pension funds are investing in hedge funds they are typically managed by very skilled fiduciaries trained to appreciate risk and screen investment options.<sup>228</sup>

Other opponents of hedge fund adviser regulation argue that the Commission's staff is overworked as it is, without the additional workload that hedge fund adviser regulation would entail.<sup>229</sup> Commissioner Paul Atkins worried publicly that the Hedge Fund Rule could have potentially diverted the "precious time and attention" of the Commission examination staff away from the mutual fund industry and onto hedge fund advisers that manage money in large part for very sophisticated investors.<sup>230</sup> The question these critics ask is whether the Commission can afford to divert any of its limited resources to the examination of hedge fund advisers, a complicated and time-consuming task.<sup>231</sup> They insist that any deterrent effect any new regulation may have had was muted by the well-known fact that the Commission lacks the resources necessary to conduct frequent hedge fund adviser examinations.<sup>232</sup>

Some of the arguments offered by critics of the Hedge Fund Rule, and there are many more, are obviously better than others. However, despite these numerous objections to domestic hedge fund adviser regulation, and before the D.C. Circuit's fateful ruling, much of the hedge fund industry was at peace with the fact that such regulation was unavoidable and was here to stay.<sup>233</sup> With the exception of initial compliance costs, many hedge fund advisers have even embraced the new regulatory scheme.<sup>234</sup>

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(Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

227. Greenwich Associates, Press Release, *Alternative Investments May Disappoint Dabblers*, January 21, 2004.

228. Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,093 (Dec. 10, 2004) (Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

229. *Hedge Fund Rules Ease Minds, Raise Questions*, REUTERS, September 9, 2005; Francesco Guerrera, Andrew Parker, and Stephen Schurr, *Managers to Face Regular Inspections*, FINANCIAL TIMES, January 30, 2006.

230. Alistair Barr, *SEC Said to Struggle Ahead of Hedge Fund Registration*, DOW JONES, September 30, 2005.

231. *SEC Scrutiny of Hedge Funds Is Good Start*, INVESTMENTS NEWS, September 26, 2005.

232. Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,093 (Dec. 10, 2004) (Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

233. *Hedge Fund Rules Ease Minds, Raise Questions*, REUTERS, September 9, 2005.

234. David Weidner, *It's Time For a Hedge Fund SRO*, DOW JONES, April 20, 2006.

## VIII. REGULATION OF HEDGE FUNDS ABROAD

The hedge fund industry is flourishing rapidly all over the world, not only in the United States.<sup>235</sup> Some have even launched hedge funds that are Sharia-compliant, acceptable within Islamic law, to attract wealthy Muslim investors.<sup>236</sup>

On October 5, 2005, the International Organization of Securities Commissions announced that it was launching a probe into the growing influence of hedge funds in the investment industry and the associated systemic and market risks posed by their growth.<sup>237</sup> Michel Prada, the French chairman of its technical committee, expressed concern at the fact that hedge funds are now marketed to individual investors in Europe.<sup>238</sup> He recommended that regulators pay close attention to their administration, risk management, and valuations.<sup>239</sup>

Other governments outside of the United States have expressed concerns about the growing influence of hedge funds and are closely scrutinizing them. The United Kingdom's Financial Services Authority ("FSA"), the chief financial regulator in the United Kingdom, published a discussion paper that discussed hedge funds' activities in the securities industry and concluded that they should be more closely monitored.<sup>240</sup> The FSA has been gathering data about hedge funds for a long time<sup>241</sup> and is considering reducing restrictions on marketing funds of hedge funds to individuals.<sup>242</sup> The FSA plans to impose restrictions on hedge funds, such as liquidity requirements, and to educate the investing public about hedge fund products.<sup>243</sup>

In Britain, every hedge fund adviser must be authorized to operate by

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235. For example, more than 330 new hedge funds were launched in Europe in 2005, raising more than \$28 billion. Andrew Ellson, *FSA to Open Retail Access to Hedge Funds*, THE TIMES OF LONDON, March 23, 2006.

236. James Altucher, *Hedge Fund Plans to Break Ground In Islamic Market*, FINANCIAL TIMES, August 23, 2005. For example, Islamic law forbids one to sell what one does not own, prohibiting short-selling. Also, Sharia prohibits making money from debt and interest payments, or from securities in companies that sell tobacco, alcohol, entertainment, or gambling. See *id.*

237. Barney Jopson and Peter Thal Larsen, *International Watchdog to Probe Risk From Hedge Funds*, FINANCIAL TIMES, October 6, 2005.

238. *Id.*

239. *Id.*

240. *Id.*

241. Liz Chong, *Hedge Funds Balk At SEC Rules*, THE TIMES OF LONDON, February 16, 2006.

242. Robert Pozen, *Reporting Standards For Hedge Funds Must Be Raised*, FINANCIAL TIMES, January 12, 2006; Andrew Ellson, *FSA to Open Retail Access to Hedge Funds*, THE TIMES OF LONDON, March 23, 2006.

243. Andrew Ellson, *FSA to Open Retail Access to Hedge Funds*, THE TIMES OF LONDON, March 23, 2006.

the government.<sup>244</sup> During an authorization process that lasts six months, a regulator is assigned to the fund and examines its business plan and the individuals who will be advising it.<sup>245</sup> When the fund is finally authorized to conduct business, which also requires that the fund put up thirteen weeks of expenses as regulatory capital, it is subject to periodic assessments by the FSA.<sup>246</sup> The British model of hedge fund regulation relies on frequent communication between regulators and hedge fund advisers.<sup>247</sup> Many hedge fund managers in the United Kingdom therefore regard the Commission's Hedge Fund Rule as unnecessary because the FSA is keeping a close watch on the hedge fund industry, which is subject to the same British rules as other financial organizations.<sup>248</sup> The FSA recently fined a partner in GLG Partners, one of London's largest hedge funds, for insider trading in the securities of Sumitomo Mitsui Financial Group Inc., the Japanese bank.<sup>249</sup>

In France, hedge funds have often been criticized as dangerous tools of "ultra-liberal capitalists" that have a strictly short-term vision of financial investments.<sup>250</sup> However, since late 2003 funds of hedge funds may sell their shares to smaller investors in France, subject to certain regulations.<sup>251</sup> Similarly, the German government has expressed concern about the growing influence of hedge funds although it has not yet implemented any plan to regulate them.<sup>252</sup> To counteract hedge fund activism, the German finance ministry stated that it will force all shareholders to make regulatory filings if their position in a company exceed 3%.<sup>253</sup> In South Africa, regulators and trade associations issued a joint discussion paper to develop regulations of hedge funds.<sup>254</sup> In the near future, more and more governments are likely to explore ways to establish oversight over the hedge fund industry.

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244. Jenny Anderson, *Lessons From the British Way of Policing Hedge Funds*, N.Y. TIMES, July 7, 2006.

245. *Id.*

246. *Id.*

247. *Id.*

248. Francesco Guerrera, Andrew Parker, and Stephen Schurr, *Deadline Approaches As SEC Takes Clippers to Hedge Funds*, FINANCIAL TIMES, January 30, 2006; Liz Chong, *Hedge Funds Balk At SEC Rules*, THE TIMES OF LONDON, February 16, 2006.

249. John Gapper, *Hedge Funds Have to Be Kept Honest*, FINANCIAL TIMES, March 20, 2006; *More Heat on Hedge Funds*, BUSINESSWEEK Online, February 6, 2006.

250. Martin Arnold, *Hedge Funds Praised for Mediepep Role*, FINANCIAL TIMES, August 17, 2005. The French often use the term "liberal" to mean "lightly regulated" or even "lawless."

251. Commission des Opérations de Bourse, *Regulating Alternative Multi-Management Investments*, News Release (Apr. 1, 2003).

252. Barney Jopson and Peter Thal Larsen, *International Watchdog to Probe Risk From Hedge Funds*, FINANCIAL TIMES, October 6, 2005.

253. Edward Taylor and Alistair MacDonald, *Hedge Funds Face Europe's Clippers*, WALL ST. J., May 23, 2006.

254. The Financial Services Board, Association of Collective Investments and Alternative Investment Management Association, *The Regulatory Position of Hedge Funds in South Africa – A Joint Discussion Paper* (Mar. 9, 2004).

## IX. ENFORCEMENT ACTIONS AGAINST HEDGE FUNDS AND THEIR ADVISERS

One serious consequence of the proliferation of hedge funds in the past ten years is that a number of incompetent or dishonest managers undoubtedly have joined the pool of working managers.<sup>255</sup> Between 1999 and 2004, the Commission brought just over fifty cases (over 10% of all its enforcement cases) charging hedge funds and their advisers or traders with defrauding investors of a total exceeding \$1 billion.<sup>256</sup> Half the advisers in these cases were managing more than \$30 million or were otherwise subject to regulation.<sup>257</sup> Importantly, the larger hedge fund advisers caused nearly all of the investor losses,<sup>258</sup> which suggests that registration would have avoided some investor harm. Between January 2004 and January 2006, the Commission brought another thirty enforcement cases against hedge funds and their advisers.<sup>259</sup> The increase in the number of enforcement cases focusing on hedge fund fraud should serve as a cautionary tale for investors in a hurry to participate in the current hedge fund craze.<sup>260</sup> The cases brought against hedge funds and their advisers have included allegations of misappropriation of assets, portfolio dumping, misrepresentation of portfolio performance, falsification of experience and past returns, misleading disclosures concerning trading strategies, and improper asset valuation, among others.<sup>261</sup>

The following, brief discussion of a few recent hedge fund Commission actions illustrates the types of issues that hedge fund investors may face if their money is placed in the wrong hands.<sup>262</sup>

The most covered hedge fund scandal to date involves a \$440 million family of hedge funds known as the Bayou Funds, based in Stamford,

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255. Rebecca Knight, *Mutual Friends Are Coming Home*, FINANCIAL TIMES, December 6, 2005 (noting that the flow of talent from the regulated world of mutual funds to the more flexible hedge fund world is not inevitable and that at least some portfolio managers are beginning to trickle back to mutual funds which are more stable).

256. *Hedge Funds Could Face Increased Regulation*, LOS ANGELES TIMES, September 12, 2005; Marcy Gordon, *SEC to Supervise Hedge Fund Industry*, ASSOCIATED PRESS, January 29, 2006; *The New Money Men*, THE ECONOMIST, February 17, 2005.

257. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,056 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

258. *Id.*

259. Francesco Guerrera, Andrew Parker, and Stephen Schurr, *Deadline Approaches As SEC Takes Clippers to Hedge Funds*, FINANCIAL TIMES, January 30, 2006.

260. *Hedge Funds Could Face Increased Regulation*, LOS ANGELES TIMES, September 12, 2005.

261. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,062-63 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279; Release No. IA-2333), available at [www.sec.gov/rules/final/ia-2333.htm](http://www.sec.gov/rules/final/ia-2333.htm).

262. The following account of Commission actions involving hedge funds is based entirely from news accounts and public documents.



Connecticut, launched in 1996, and controlled by Samuel Israel III and Daniel E. Marino through Bayou Management, LLC.<sup>263</sup> In late September 2005, the Commission charged Bayou and its management with fraud, alleging that they had attracted investors by exaggerating Bayou's performance and had misappropriated millions of dollars in investor funds for their personal use.<sup>264</sup> Among other charges, the Commission alleged that Bayou overstated its 2003 performance by claiming over \$43 million in net gain from investment transactions even though trading records in fact showed a \$49 million loss during that period of time.<sup>265</sup> In addition, Bayou had claimed that its books had been reviewed by independent auditors when in fact they were certified by an accounting firm whose registered agent was none other than Bayou's chief financial officer.<sup>266</sup> That accounting firm allegedly fabricated "independent" audit reports to buy Bayou some time to make up its huge losses.<sup>267</sup>

Bayou Securities, Bayou's brokerage unit, generated over \$50 million in revenue executing trades for its four affiliated hedge funds.<sup>268</sup> Not only did the use of an affiliated brokerage unit create a potential for conflicts of interest, but Bayou lied to its investors concerning the amount of its commissions.<sup>269</sup> Among other illegal transactions, Bayou entered into a transaction to invest over \$120 million in fraudulent "prime bank" instruments designed to recoup the enormous losses that Bayou had sustained.<sup>270</sup> Arizona authorities eventually seized that money.<sup>271</sup>

In late September 2005, Bayou's founder and chief financial officer both pleaded guilty in federal court to charges of conspiracy and fraud.<sup>272</sup> The apparent egregiousness of this case underscores the risks associated with hedge funds and has inspired calls for greater regulation of this loosely regulated investment niche.<sup>273</sup>

In October 2005, the Commission announced it was filing a lawsuit

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263. See Complaint, available at <http://www.sec.gov/litigation/complaints/comp19406.pdf>; SEC Litigation Release 19406, September 29, 2005, available at <http://www.sec.gov/litigation/litreleases/lr19406.htm>.

264. See Complaint, available at <http://www.sec.gov/litigation/complaints/comp19406.pdf>; SEC Press Release 2005-139, September 30, 2005, available at <http://www.sec.gov/news/press/2005-139.htm>.

265. See Complaint, available at <http://www.sec.gov/litigation/complaints/comp19406.pdf>; SEC Press Release 2005-139, September 30, 2005, available at <http://www.sec.gov/news/press/2005-139.htm>.

266. See Complaint, available at <http://www.sec.gov/litigation/complaints/comp19406.pdf>.

267. *Id.*

268. *Id.*

269. *Id.*

270. *Id.*

271. *Id.*

272. *Hedge Fund Founder, CFO Plead Guilty in Fraud Case*, CHI. TRIB., 2005.

273. Stephen Labaton, *Judges Weigh Hedge Funds vs. the SEC*, N.Y. TIMES, December 10, 2005; *Hedge Fund Rules Ease Minds, Raise Questions*, REUTERS, September 9, 2005.

against Wood River Partners LP, Wood River Partners Offshore Ltd., and John Whittier, the funds' manager.<sup>274</sup> The Commission alleged that Whittier made material misrepresentations regarding the oversight and diversification of the two hedge funds in question.<sup>275</sup> Contrary to representations in offering materials concerning diversification, the funds had amassed a huge position in a single small-cap stock.<sup>276</sup> Wood River, which purportedly managed \$275 million in assets,<sup>277</sup> reported in a June 2005 letter to investors a very high 32% annualized return since its inception and plans to open new offices and hire more staff.<sup>278</sup>

Another widely reported hedge fund scandal involves Millennium Partners LP which agreed, along with its founder and its chief operating officer, to pay \$180 million to settle allegations by both the Commission and New York Attorney General Eliot Spitzer that it engaged in fraudulent trading of mutual funds.<sup>279</sup> Specifically, it engaged in market timing, the rapid buying and selling of mutual funds' shares which may dilute the value of long-term investors' holdings.<sup>280</sup> The Commission stated in its litigation release that Millennium created 100 legal entities with unrelated names, and opened 1,000 accounts at various brokerage firms, to conceal that its market timing trades were executed by the same entity.<sup>281</sup>

The Commission has pursued vigorously many other hedge funds that garnered large profits from both market timing and late trading. For example, it filed suit against the managers of the Ilytat hedge fund, accusing them of making more than 3,000 trades after the market closed.<sup>282</sup> That illegal practice, called late trading, allows favored investors such as hedge funds to take advantage of market-moving information before it can be reflected in closing mutual-fund prices.<sup>283</sup> Late traders typically buy or sell securities after the 4 p.m. close of the market to take advantage of news released after that time.<sup>284</sup>

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274. *SEC Hits Wood River Hedge Funds with Fraud Suit*, N.Y. POST, October 14, 2005.

275. See Complaint, available at <http://www.sec.gov/litigation/complaints/comp19428.pdf>

276. *Id.*

277. Gregory Zuckerman, Deborah Solomon, and Ian McDonald, *SEC Probes Idaho Hedge Fund*, WALL ST. J., October 8, 2005.

278. Gregory Zuckerman, Deborah Solomon, and Ian McDonald, *SEC Probes Idaho Hedge Fund*, WALL ST. J., October 8, 2005.

279. Andrew Parker, *Hedge Fund to Settle With US Regulators*, FINANCIAL TIMES, December 2, 2005; see Order, available at <http://www.sec.gov/litigation/admin/33-8639.pdf>.

280. Andrew Parker, *Hedge Fund to Settle With US Regulators*, FINANCIAL TIMES, December 2, 2005.

281. See Order, available at <http://www.sec.gov/litigation/admin/33-8639.pdf>.

282. See Complaint, available at <http://www.sec.gov/litigation/complaints/comp19510.pdf>; Siobhan Hughes, *SEC Sues Managers of Ilytat, Gage Hedge Funds*, DOW JONES, December 22, 2005.

283. Siobhan Hughes, *SEC Sues Managers of Ilytat, Gage Hedge Funds*, DOW JONES, December 22, 2005.

284. Scott Bernard Nelson, *Late Trading May Be More Widespread Than Thought*, BOSTON GLOBE, September 12, 2003; [www.sec.gov/litigation/litreleases/lr18738.htm](http://www.sec.gov/litigation/litreleases/lr18738.htm) (June 4, 2004).

The Commission also charged the manager of Bingham Growth Partners L.P. with fraud for misleading investors concerning his fund's returns and for stealing from the fund's assets.<sup>285</sup> He allegedly raised at least \$460,000 from investors using fake returns.<sup>286</sup> Other funds, such as the Critical Infrastructure Fund, allegedly inflated the value of certain investments and may have failed to write down their value when these investments performed poorly.<sup>287</sup> In the case of Global Money Management, L.P., the Commission alleged that the fund's principals, who never disclosed their disciplinary history with the NASD, falsely told investors that the fund held assets ranging from \$60 million to over \$100 million.<sup>288</sup> In fact, the Commission alleged that securities held by the fund had been worth closer to \$11 million since early 2003, based on brokerage records.<sup>289</sup>

Some hedge funds the Commission brought actions against never even traded at all. The Commission charged Bret Grebow and Robert Massimi with fraud, alleging that the New Jersey-based hedge fund they managed, HMC International LLC, was nothing more than a Ponzi scheme.<sup>290</sup> The Commission's complaint alleges that they took in more than \$5.2 million from investors and sent investors fake monthly statements even though the fund had not traded in months.<sup>291</sup> The fund had represented itself has a low-risk "day trading" fund to prospective investors.<sup>292</sup> Similarly, the Commission sued the head of The Pembridge Group, supposedly a \$600 million offshore fund, alleging that the fund did not even exist and that he operated a penny stock pump-and-dump scheme.<sup>293</sup>

The preceding look at some of the largest hedge fund frauds highlights some important lessons that can be learned in order to avoid being defrauded by a hedge fund. First, investors should conduct due diligence on the fund before investing, including verifying the fund's promotional materials or

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285. *SEC Charges Hedge Fund with Fraud*, REUTERS NEWS, August 24, 2005; see also Order, available at <http://www.sec.gov/litigation/admin/34-52318-o.pdf>.

286. *Atlanta Man Accused of Hedge Fund Scam*, CNNMoney.com, August 24, 2005.

287. Chad Bray, *SEC Sues Ex-Hedge Fund Mgr Saying Fund Was Overvalued*, DOW JONES, September 28, 2005, SEC Litigation Release 19427, October 13, 2005, available at <http://www.sec.gov/litigation/litleases/lr19427.htm>.

288. SEC Litigation Release 18666, April 12, 2004, available at <http://www.sec.gov/litigation/litleases/lr18666.htm>.

289. *Id.*

290. Gregory Zuckerman, *SEC Charges Hedge-Fund HMC Principals of Fraud*, WALL ST. J., December 22, 2005. A "Ponzi scheme" is a scheme whereby new investor funds are used to meet the redemptions of existing investors. See *United States v. Moloney*, 287 F.3d 236, 242 (2d Cir. 2002); *United States v. Kennedy*, 64 F.3d 1465, 1480 (10th Cir. 1995).

291. Gregory Zuckerman, *SEC Charges Hedge-Fund HMC Principals of Fraud*, WALL ST. J., December 22, 2005, see also SEC Litigation Release 19508, December 21, 2005, available at <http://www.sec.gov/litigation/litleases/lr19508.htm>.

292. Jenny Anderson, *SEC Accuses a New Jersey Hedge Fund*, N.Y. TIMES, December 22, 2005.

293. SEC Litigation Release 18957, November 3, 2004, available at <http://www.sec.gov/litigation/litleases/lr18957.htm>.

offering memorandum and calling the hedge fund's attorneys and accountants to make sure they exist and all belong to reputable firms.<sup>294</sup> Using professional investigative services and Internet resources, including the Commission's website,<sup>295</sup> investors can conduct a background check on the hedge fund's manager,<sup>296</sup> check for employment track records and disciplinary actions,<sup>297</sup> and look for red flags such as padded resumes and shady credit histories.<sup>298</sup> If the principals of the fund have a criminal or regulatory history, filed for bankruptcy, or exaggerated their experience in their resume or promotional materials, investors ought to stay away.<sup>299</sup> Second, investors should stay away from hedge funds where advisers have ties to the fund's accounting firm. Bayou's chief operating officer was allegedly the registered agent for the accounting firm that Bayou told investors was doing independent audits of its books, a fact that could have been discovered with a little research.<sup>300</sup> Third, investors ought to avoid hedge funds that trade through an affiliated broker.<sup>301</sup> Indeed, trading through independent brokers encourages the fund to bargain over trading commissions, which benefits investors.<sup>302</sup> Fourth, investors should pay careful attention to the fund's liquidity provisions. Some funds give their investors very little opportunity to redeem their investments and enable their managers to suspend all redemptions in certain circumstances.<sup>303</sup> Investors may also want to look at a fund's volatility to determine if the fund matches the investor's tolerance and outlook. Finally, investors should monitor a fund's advertised returns and compare these returns against the manager's peer group to make sure that the returns are real and the fund is performing well on a comparative basis.<sup>304</sup> Some commentators have called for the creation of a self-regulatory organization to eliminate the need for investors

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294. David Weidner, *It's Time For a Hedge Fund SRO*, DOW JONES, April 20, 2006.

295. Found at [www.sec.gov](http://www.sec.gov), the Commission's website contains much valuable information on past infractions and prior and ongoing litigation.

296. Jane J. Kim, *Digging for Hedge Fund Dirt*, WALL ST. J., August 8, 2005.

297. Geraldine Fabrikant, *Want a Hedge Fund? Here's Your Homework*, N.Y. TIMES, September 11, 2005.

298. *Hedge Fund Sleuths*, BUS. WK., November 21, 2005. In the case of Bayou, its manager marketed himself as a former senior trader at Omega Advisors Inc. even though he had only worked at that firm for eighteen months and was employed in a junior position. Ianthe Jeanne Dugan and Ian McDonald, *Investigators Say Bayou's Assets May Be Missing*, WALL ST. J., August 26, 2005.

299. Erin Arvedlund, *Spotting a Bayou Before You Fall Into It: A Checklist for Hedge Fund Investors*, WALL ST. J., August 31, 2005. Lexis-Nexis and Pacer, an online index to federal civil and criminal cases nationwide, are available tools in this due diligence process. Geraldine Fabrikant, *Want a Hedge Fund? Here's Your Homework*, N.Y. TIMES, September 11, 2005.

300. See Complaint, available at <http://www.sec.gov/litigation/complaints/comp19406.pdf>.

301. Erin Arvedlund, *Spotting a Bayou Before You Fall Into It: A Checklist for Hedge Fund Investors*, WALL ST. J., August 31, 2005.

302. *Hedge Fund Sleuths*, BUS. WK., November 21, 2005.

303. Deborah Brewster, *Bayou Mystery Raises Fund Fears*, FINANCIAL TIMES, August 31, 2005.

304. Erin Arvedlund, *Spotting a Bayou Before You Fall Into It: A Checklist for Hedge Fund Investors*, WALL ST. J., August 31, 2005.

to conduct such extensive due diligence on hedge funds.<sup>305</sup>

## X. CONCLUSION

Hedge funds promise an investment strategy that earns above-average returns when the market rises and when it falls. In the past five years, the hedge fund industry has grown tremendously and has taken more risks in its investments to attempt to maintain high returns. Helping fuel this growth has been the fact that many hedge funds have sought investments from less affluent and sophisticated investors than in the past. In addition, the number of securities enforcement cases filed against hedge funds has increased. As a result, many have called for some form of regulatory oversight to protect the investing public and reduce market risks.

After reviewing the matter closely the Commission concluded that hedge funds may pose a threat to investment consumers and to financial stability and attempted to act proactively and responsibly to avoid unnecessary harm to investors. The Hedge Fund Rule promulgated by the Commission, now vacated, may have provided this needed regulation and would have allowed the Commission to look at hedge fund advisers who were not subject to regulatory oversight in the past. Despite this temporary setback, the Commission unanimously adopted a new antifraud rule under the Advisers Act, designed to protect investors in pooled investment vehicles. This new antifraud rule, along with the attention hedge funds have been receiving from the press, should deter at least some wrongdoers, and allow the Commission's staff to detect fraudulent conduct at an early stage.

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305. David Weidner, *It's Time For a Hedge Fund SRO*, DOW JONES, April 20, 2006.